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In the Supreme Court of the United States

OCTOBER TERM, 1980

ROBERT W. MESERVE AND BENJAMIN H. LACY, REORGANIZATION TRUSTEES OF THE BOSTON AND MAINE CORPORATION, DEBTOR, and THE FIRST NATIONAL BANK OF BOSTON AND MALCOLM W. HALL, SUCCESSOR INDENTURE TRUSTEES,

PETITIONERS,

v.

CHESAPEAKE AND OHIO RAILWAY COMPANY, MAINE CENTRAL RAILROAD COMPANY, PENN CENTRAL CORPORATION, CANADIAN PACIFIC, and EASTERN ASSOCIATED COAL CORPORATION, ET AL,

RESPONDENTS.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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I

Questions Presented

1. In railroad reorganization proceedings, should a priority under the so-called Six Months Rule be recognized in the absence of a current debt fund or equitable grounds for re-creating such a fund? More particularly, if during the period of the reorganization proceedings and during the six months prior thereto there is no net railway operating income and no inequitable diversion of operating revenues for the benefit of mortgagees, should the corpus of mortgaged property be invaded at the expense of the mortgagees to provide priority payments to pre-petition unsecured creditors?

2. Should a deduction from operating revenues for depreciation expense be denied in determining the existence of a current debt fund?

Parties

Petitioners herein are the reorganization trustees of the estate of the Boston and Maine Corporation, Debtor, and The First National Bank of Boston and Malcolm W. Hall, successor indenture trustees under the indenture pursuant to which the Debtor's first mortgage bonds are outstanding. The Respondents are the Chesapeake and Ohio Railway Company, Baltimore and Ohio Railway Company, Western Maryland Railway, Maine Central Railroad Company, Portland Terminal Company, and Eastern Associated Coal Corporation.

For purposes of Supreme Court Rule 28.1, it is hereby disclosed that: (a) the Reorganization Trustees of the Boston and Maine Corp., Debtor, as such, own stock in or are otherwise affiliated with the following companies: Springfield Terminal Railway Co., Stony Brook Railroad, Northern Railroad, Vermont and Massachusetts Railroad, Mystic Terminal Co., Pullman Co., Pine Tree Corp., Connecticut River Valley Co., Inc., Trailer Train Co., North Station Industrial Building, Inc., and North Station Hotel Building, Inc.; (b) The Co-petitioner, The First National Bank of Boston ("The Bank") is, except for directors' qualifying shares, a wholly-owned subsidiary of First National Boston Corporation ("The Parent").

II

The Bank has no direct or indirect material beneficial interest in this litigation but is acting solely in its fiduciary capacity as corporate trustee of the First Mortgage Indenture of Boston and Maine Corporation, and is uncertain whether under this circumstance Rule 28.1 contemplates that its individual corporate affiliations be listed. Such affiliations do not attach to the trustees as such under said mortgage. Those affiliations are as follows:

The Bank

The Bank is a national banking association with its principal office in Boston, Massachusetts. Except for directors' qualifying shares, all of its outstanding stock is held beneficially and of record by the Parent. The Bank has a number of wholly-owned subsidiaries one or more of which, in turn, has one or more wholly-owned subsidiaries. Except as hereinafter stated, all of the Bank's subsidiaries are wholly-owned, directly or indirectly (except in some cases for directors' qualifying shares).

The Bank's Parent - First National Boston Corporation

The Parent is a registered bank holding company with its principal office in Boston, Massachusetts. Its outstanding stock is publicly held and is listed and traded on the New York and Boston Stock Exchanges. The Parent has a substantial number of banking and financial subsidiaries many of which subsidiaries are directly held and many of which are held indirectly through various subsidiaries. Except as hereinafter mentioned, all of such subsidiaries of the Parent are wholly-owned directly or indirectly (except in certain cases for directors' qualifying shares).

Exceptions Relating to the Bank

The Bank has a wholly-owned subsidiary, Boston Overseas Financial Corporation, which is a United States Edge Act corporation. This wholly-owned subsidiary has direct ownership interests in a number of financial entities organized under the laws of, and operating in, various foreign countries. Some of such entities are wholly-owned directly or indirectly. A number of such entities are partly-owned. Except in the instance mentioned

below, the "outside" ownership interests in such partly-owned entities are held by one or more banks or other financial institutions organized and operating under the laws of foreign countries none of which are affiliates of the Bank or the Parent. In some cases, the outside ownership interests are wholly or partly held by individuals who are foreign nationals who are not otherwise affiliated with the Bank or the Parent.

An indirectly wholly-owned subsidiary of the Bank is a 20% joint participant in a small Brazilian enterprise, the outstanding 80% interest in which is owned by a wholly-owned subsidiary of PHH Group, Inc., a publicly-held domestic corporation whose stock is traded and listed on a national securities exchange.

The assets of all such entities if considered in the aggregate, and if considered to be owned by a single subsidiary, would not constitute such subsidiary to be a significant subsidiary of the Bank or the Parent.

Exceptions Relating to the Parent

(A) The Parent, through a wholly-owned subsidiary, owns 50% of the outstanding stock of First National Computeristics, Inc., a Massachusetts corporation, the balance of whose outstanding stock is owned indirectly by Uniroyal, Inc., which is a domestic publicly-owned corporation whose common stock is traded and listed on a national securities exchange.

(B) Until recently, the Parent, through several separate single purpose indirectly wholly-owned subsidiaries, had been engaged in a tanker leasing program involving three 265,000 deadweight ton U.S. flag tankers. In August of 1980, the Parent entered into an agreement to sell all of its stock in said subsidiaries to Tenafly VLCC Holdings, Inc., a privately-held company, for notes guaranteed by Seatrain Lines, Inc., a publicly-held corporation whose stock is traded and listed on a national securities exchange; 49% of the stock of said single purpose subsidiaries has been sold and transferred to Tenafly and the remaining 51% of stock will be transferred to Tenafly at the conclusion of statutory waiting periods required under the pre-merger notification provisions of the Hart-Scott-Rodino Antitrust Improvements Act of 1976.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Petitioners, who are, respectively, the Trustees in Reorganization of the estate of the Boston and Maine Corporation, Debtor in pending railroad reorganization proceedings, and the Indenture Trustees under the Indenture pursuant to which the Debtor's first mortgage bonds are outstanding, respectfully pray that a writ of certiorari issue to review that part of the judgment and

opinion of the United States Court of Appeals for the First Circuit entered on October 6, 1980 which reversed the District Court's Order of March 19, 1979 insofar as the latter classified creditors without providing for a priority classification under the so-called Six Months Rule.

Opinion Below

The opinion of the Court of Appeals is reproduced as Appendix A hereto (pp. A1-A47).

Jurisdiction

The judgment of the Court of Appeals was entered on October 6, 1980. By order dated December 29, 1980, this Court granted an extension of the time within which to file this petition for a writ of certiorari to and including January 15, 1981. This petition for a writ of certiorari was filed prior to that date. This Court's jurisdiction is invoked pursuant to 28 U.S.C. Section 1254(1).

Statute Involved

Section 77(b) of the Bankruptcy Act, 11 U.S.C. 205(b) (1976) provides in pertinent part:

> For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.

The foregoing provision is applicable to cases, such as the case at bar, which were pending under Section 77 of the Bankruptcy Act on the date of enactment of the Bankruptcy Reform Act of 1978 and in which the trustee had filed a plan of reorganization. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, §403(b), 92 Stat. 2549 (1978).[1]

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[1] As to other cases, the statutory rule is set forth in section 1171(b) of the Bankruptcy Code, 11 U.S.C. § 1171(b) (as amended) which provides:

Statement of the Case

On March 12, 1970, an involuntary petition pursuant to Section 77 of the Bankruptcy Act (the "Act"), 11 U.S.C. § 205 (1976), was filed against the debtor Boston and Maine Corporation in the United States District Court for the District of Massachusetts ("Reorganization Court"). The involuntary petition for reorganization was thereafter approved by the Reorganization Court and the Reorganization Trustees were appointed as such by Order dated April 24, 1970.

On or about November 4, 1977 the Trustees filed a petition requesting that the Reorganization Court approve the Trustees' proposed classification of claims pursuant to Section 77(c)(7) of the Act. The proposed classification was substantially consistent with the Trustees' proposed plan of reorganization dated December 12, 1975, and did not provide for any priority based upon the so-called Six Months Rule (hereinafter referred to as "Rule" or "Six Months Rule"). Objections to the proposed classification were filed by the Respondents herein, pre-petition unsecured creditors of the Debtor

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Any unsecured claim against the debtor that would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the date of the order for relief under this title shall be entitled to such priority in the case under this chapter.

The preceding provision of the Bankruptcy Code is applicable both to cases pending under Section 77 of the Bankruptcy Act on the date of enactment of the Bankruptcy Reform Act of 1978 in which the trustee had not filed a plan of reorganization and to subsequently filed railroad reorganization cases. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, §§ 403(a), (b), 92 Stat. 2549 (1978).

Because the Reorganization Trustees filed a plan of reorganization prior to enactment of the Bankruptcy Reform Act of 1978, this case is governed by the provisions of the Bankruptcy Act and not the Bankruptcy Code. There is, however, no substantive difference between the above-quoted provisions; thus, the issues raised by this Petition are issues that can be resolved for purposes of future as well as pending railroad reorganization cases. Additionally, as hereinafter discussed, the Code provision and its legislative history provide further reason for the grant of the writ.

who claimed, *inter alia*, entitlement to priority under the Six Months Rule. The points at issue before both the Reorganization Court and the Court of Appeals with respect to the Six Months Rule were the same threshold questions presented on this Petition. While the scope and prerequisites to application of the Rule are at issue on this Petition, it is generally agreed that if applicable, the Rule provides a priority ranking junior to post-petition administration expense claims but senior to the claims of the railroad's lien creditors and mortgage bond holders[2] for those pre-petition unsecured claims against the Debtor which represent a current operating expense of the railroad necessarily incurred[3] within six months prior to the filing of the reorganization petition[4] and which arise from the provision of goods or rendition of services in reliance on the railroad's current earnings and not in reliance on the railroad's general credit[5] (claims meeting such requirements are hereinafter referred to as "Six-Months claims").

Factual questions as to whether a particular creditor's claim met these specific requirements of the Rule were deferred pending resolution of the fundamental question of whether a Six Months priority could be recognized or applied at all in the absence of a current debt fund or equitable grounds for re-creating such a fund and whether such a fund or grounds existed in this case.

Based on decisions of this Court which have articulated the rationale and delineated the parameters of the Rule as it developed in railroad equity receiverships predating Section 77 proceedings,[6]

[2] *In re Penn Central Transp. Corp.*, 458 F.Supp. 1234, 1321 (E.D. Pa. 1978).

[3] *Burnham* v. *Bowen*, 11 U.S. 776, 780 (1884).

[4] *Southern Ry. Co.* v. *Carnegie Steel Co.*, 176 U.S. 257, 292 (1900).

[5] *Id.* at 285. *In re Penn Central Transp. Corp.*, 458 F.Supp. 1234, 1321, (E.D. Pa. 1978); *In re New York, N.H. & H. R.R. Co.*, 278 F.Supp. 592, 596-98 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969).

[6] *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905); *Southern Ry.* v. *Carnegie Steel Co.*, 176 U.S. 257 (1900); *Kneeland* v. *American Loan Co.*, 136 U.S. 89 (1890); *Burnham* v. *Bowen*, 111 U.S. 776 (1884); *Fosdick* v. *Schall*, 99 U.S. 235 (1878).

and based on decisions of the Courts in the Second and Third Circuits[7] which have applied that learning, it was, and is, the Petitioners' position that the Six Months Rule is a rule of equitable restitution which establishes a priority for creditors holding Six Months claims only to the extent that there exists for the relevant period what has come to be called a "current debt fund"[8] consisting of net railway operating income remaining after payment or provision for all operating expenses, including depreciation expense, and/or operating revenues inequitably diverted to or for the benefit of mortgagees. The Rule is premised on an implied agreement of railroad mortgagees that current expenses of the road are to be paid out of operating revenues before the mortgagees' interest in those revenues attaches.[9] Hence, when operating revenues exceed expenses, that excess must be paid to the unpaid pre-petition current expense creditors prior to its payment to mortgagees. If operating revenues have been diverted from current expense creditors to pay mortgagees, the corpus of mortgaged property may be invaded to the extent of the diversion if sufficient surplus current revenues do not exist to to pay those creditors.[10] Therefore, in the absence of surplus earnings any recognition of a priority for Six Months claims necessarily results in the invasion of the mortgaged property. To recognize a priority under the Rule in other than the above-named circumstances would impair the rights of mortgagees without warrant and provide one group of pre-petition unsecured creditors a preferential payment not available to other pre-petition unsecured creditors.

In light of the substantial losses of the Debtor prior to the filing of the reorganization petition and of the estate subsequent

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[7] *In re Penn Central Transp. Corp.*, 458 F.Supp. 1234 (E.D. Pa. 1978); *In re New York, N.H. & H.R.R. Co.*, 278 F.Supp. 592 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969).

[8] *Fosdick* v. *Schall*, 99 U.S. 235, 252 (1878).

[9] *Id.*

[10] *Id.* at 254.

thereto, recognition of a priority under the Rule would require the Trustees to divert several million dollars from the corpus of mortgaged property to satisfy Six Months claims. (C 4).

Relying on two cases[11] which had been uniformly discredited until the Court of Appeals opinion which is the subject of this Petition, it was, and is, the Respondents' position that all that was required to establish priority under the Rule was the provision of necessary goods and services within the six months immediately preceding the filing of the reorganization petition in reliance on the railroad's current revenues.

As to whether the facts of this case established the existence of a current debt fund or grounds for re-creating such a fund, the Reorganization Trustees answered interrogatories propounded by certain Respondents and stipulated as fact relevant data. The aforesaid Answers and Stipulation are reproduced as Appendix C hereto. Additionally, pursuant to an Order of the Reorganization Court dated February 5, 1979, the Reorganization Trustees filed a computation utilizing relevant financial data which indicated that no diversion for the benefit of mortgagees existed. The aforesaid Order and Computation are reproduced as Appendix D hereto.

The Reorganization Court conducted a hearing on the proposed classification and the objections thereto on November 13, 1978. The Court issued its Memorandum of Decision on March 12, 1979, 468 F.Supp. 996 (D. Mass. 1979) and its Order on March 19, 1979 (reproduced as Appendix B hereto). To the extent pertinent to the issues presented on this Petition, the Reorganization Court held that a current debt fund must exist or be re-created to entitle otherwise qualified Six Months claims to a priority. (B5-6). Essentially following the analysis of Judge Anderson in the second New Haven reorganization[12] (other than

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[11] *Southern Ry. Co.* v. *Flournoy*, 301 F.2d 847 (4th Cir. 1972); *In re Tennessee Central Ry. Co.*, 316 F.Supp. 1103 (M.D. Tenn. 1970), *vacated*, 463 F.2d 73 (6th Cir..), *cert. denied*, 409 U.S. 8993 (1972).

[12] *In re New York, N.H. & H.R.R. Co.*, 278 F.Supp. 592 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969) (hereinafter referred to as "*New Haven*").

his treatment of unmortgaged assets) and Judge Fullam's analysis in the Penn Central reorganization[13], the Reorganization Court held that the current debt fund consisted of surplus current earnings during the course of the reorganization and the six months prior thereto and income diverted during that period for the benefit of mortgagees. (B7-10). Surplus current earnings were defined as the sum of all operating revenues accrued during the relevant period which were actually received or taken over by the Trustees less depreciation expense and all other operating expenses paid or payable by the Trustees or which constituted administration expenses. (B8). The Reorganization Court further held that the deduction of depreciation expense does not enhance the mortgaged assets but is more akin to an expenditure to preserve the assets and as such is not a diversion. (B13). On the basis of the foregoing and upon the evidence submitted, the Reorganization Court concluded that there was no surplus current operating revenue during the relevant period to constitute the required current debt fund (B8-9, 13-14) and that there existed no net diversion in favor of mortgagees. (B12-13). Accordingly, the Court concluded that no provision should be made for a separate class of creditors having priority under the Six Months Rule and subsequently ordered a classification of creditors which did not provide for such a priority class.

On appeal, the Court of Appeals reversed in part the Reorganization Court for its failure to provide a separate class of creditors having priority under the Six Months Rule and remanded the case for further proceedings consistent with that decision.

The Court of Appeals rejected the view that the existence of a current debt fund or grounds to re-create such fund was prerequisite to recognition of a priority under the Rule. Rather, the Court held that application of the Rule was supported by either one of two co-existing but distinct principles. (A34-35). The first principle, which the Court characterized as one of mortgage law despite its derivation and effect, is one of equitable restitution

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[13] *In re Penn Central Transp. Corp.*, 458 F.Supp. 1234 (E.D. Pa. 1978) (hereinafter referred to as "*Penn Central*").

as exemplified in *Fosdick* v. *Schall*, 99 U.S. 235 (1878). (A35). A priority premised on this principle does require the existence of a current debt fund, determined essentially as indicated in *New Haven* and in *Penn Central* except the Court held that depreciation expense is not to be deducted from operating income in determining the amount of the fund. (A42-45). The second "principle" supporting application of the Rule is one which the Court of Appeals characterized as a principle of receivership administration which it found reflected in this Court's decision in *Miltenberger* v. *Logansport C. & S.W. Ry. Co.*, 106 U.S. 286 (1882). (A35). That principle, premised by the Court of Appeals on the public interest in the uninterrupted operation of a railroad, calls for the payment of Six Months claims on the same basis and from the same operating income as post-petition expenses of administration. (A41). The Court's equating the pre-petition current expense creditor with the post-petition administration expense creditor appears to imply that the priority accorded under this "receivership administration principle" may be satisfied out of the corpus of mortgaged property when there are insufficient operating revenues to pay all such claims and administration expenses, even though there has been no diversion of operating revenues for the benefit of mortgagees.

The Court of Appeals rejected the contention of the Reorganization Trustees that *Miltenberger* simply expressed a "Necessity of Payment" rule under which a receiver or trustee was justified in paying pre-petition claims if, and only if, the non-payment of such claims would threaten the continued operation of the railroad. (A37-38). The Court of Appeals essentially converted *Miltenberger* from a case involving only the necessity of a payment to a case involving the establishment of priorities. In so doing, the First Circuit Court's decision is directly contrary to this Court's view of *Miltenberger* as expressed in *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905), and indeed

restates a prior and similar interpretation of *Miltenberger* by the First Circuit Court (see pages 23-27 *infra*) which was cited and repudiated by this Court in *Gregg*. Further, the decision of the First Circuit Court of Appeals in the case at bar is in conflict with recent congressional action.

As previously noted, the Court of Appeals held that when a priority is claimed under the *Fosdick* rule, a current debt fund must exist and that the deduction of depreciation expense from current revenue was an improper deduction in the calculation of that fund. (A41-44). In arriving at this conclusion, the Court did acknowledge that depreciation is a "[c]ost. . . to produce the revenue of that period" (A43) but failed to explain why such a cost to produce revenue should not be treated as a deduction against revenue to the same extent as other costs to produce revenue, and further failed to explain why such a deduction would be inequitable from the perspective of operations creditors. The Court incorrectly concluded that a deferment of current operating expenses to depreciation charges would constitute a direct set-aside of revenue for the mortgage bondholders at the cost of current expense creditors (A44-45), and failed to state why this is unreasonable in the circumstances. The Court failed to recognize depreciation as representing the mortgagees' contribution to the production of current revenues. Furthermore, the Court appears to have assumed that there existed a fund of cash available for distribution as a consequence of the deduction of the depreciation charge and that such cash had not been consumed by operating losses. When, as in the case at bar, there is a deficit in net railway operating income apart from the depreciation charge, a priority in favor of current expense creditors would necessarily have to be paid out of the corpus of mortgaged property with the result that mortgagees would inequitably suffer not only the loss in the value of their security reflected by depreciation, but would also suffer the additional loss of the security used to pay the priority.

Reasons for Granting the Writ

I. The Decision Below Conflicts With Decisions of Other Courts of Appeals

The decision by the Court of Appeals for the First Circuit that a priority for Six Months claims may be recognized regardless of the existence of a current debt fund and that depreciation expense is not a proper deduction from current revenue in the determination of the existence of such a fund is inconsistent with decisions of other Courts of Appeals.

A. *The Second Circuit*

In *In re New York, N.H. & H. R.R. Co.*, 405 F.2d 50 (2d Cir. 1968), the Court of Appeals for the Second Circuit affirmed the District Court's denial of priority status to unsecured creditors claiming priority status under the Six Months Rule. The Court stated:

> Whether the six months creditors receive priority depends, however, on whether there existed a 'current debt fund' or 'current expense fund' from which payment could have been made but which was used instead for the benefit of the bondholders.

405 F.2d at 52.

The court further held that depreciation expense should be deducted from current revenue in the determination of the existence of the fund.

> We hold that the availability of a current expense fund under the six-months rule is to be determined by generally accepted accounting practices, including those prescribed by the Interstate Commerce Commission, and that under those practices the current expense fund is to be computed by deducting operating expenses and depreciation from operating revenues.

Id.

The District Court opinion affirmed by the Court of Appeals confirms both the restitutional nature of the Six Months Rule and the necessity of a current debt fund out of which the priority may be paid. 278 F.Supp. at 598. In discussing the Rule's rationale, the District Court rejected the importance of currently furnished goods and services to the continued operation of the railroad as a basis for the Rule.

> Most cases contain additional rhetoric to the effect that extensions of credit by those furnishing operating services and materials have "kept the railroad running." This continued operation of the railroad is then said to be a benefit to the public and to the mortgagees as well, because the railroad is worth more as a going concern than its liquidation value. Hence a priority should be granted to the operations creditors. However, given the railroad reorganization provisions of Section 77 of the Bankruptcy Act (11 U.S.C. Section 205), it is simply not true in circumstances like those facing the New Haven that extensions of credit by suppliers of operating materials and services keep a railroad from ceasing to run. Should these suppliers withhold credit and demand cash, the railroad would not go into liquidation; it might have to go into reorganization so much the sooner, but it would keep running until a plan of reorganization was approved or liquidation was decreed.

Id. at 598 n.10.

The foregoing view is in direct contradiction to much of the First Circuit's rationale with respect to its second "principle" justifying recognition of a priority for Six Months claims. (see page 8, *supra.*)

As to the circumstances under which the corpus of mortgaged property may be invaded to pay the Six Months priority, the District Court stated:

> On the question of invasion of corpus the Supreme Court has consistently held in every decision on the point that

> corpus cannot be invaded to satisfy the priority of the operations creditors except to the extent that the current expense fund has been "diverted" to the benefit of the mortgagees. *See, e.g., Fosdick* v. *Schall*, 99 U.S. at 254, 25 L.Ed. 339 '[I]f there has been in reality no diversion, there can be no restoration; . . . the amount of restoration should be made to depend upon the amount of the diversion.'; *St. Louis, A. & T.H. R.R. Co.* v. *Cleveland, C., C. & I.R. Co.*, 125 U.S. 658, 674, 8 S.Ct. 1011, 31 L.Ed. 832 (1888); *Gregg* v. *Metropolitan Trust Co., supra*. This limiting of corpus invasion to the amount of diversion of the fund is entirely consistent wtih (sic) the rationale of the rule. If the current revenues to which operations creditors are entitled, have never benefited or been diverted to the mortgagees, the operations creditors have no right to invade the interests of the mortgagees. The rule states that mortgagees shall not take any of the operating revenues until the operations creditors have been paid; if the mortgagees have never received any such revenues, they are not bound to restore any.

Id. at 602-03 (footnotes omitted).

Addressing this Court's decision in *Miltenberger* and the subsequent interpretation of that decision by the Court of Appeals for the Fourth Circuit in *Southern Ry. Co.* v. *Flournoy*, 301 F.2d 847 (4th Cir. 1972), a decision remarkably akin to that of the First Circuit in regard to the interpretation and application of *Miltenberger*, Judge Anderson stated:

> One lower federal court has misread the Supreme Court's holdings on this point. *Southern Railway Company* v. *Flournoy*, 301 F.2d 847 (4 Cir. 1962). The *Flournoy* court confused and merged the six months rule with another priority developed in equity receiverships: the so-called "necessity of payment" rule. This rule is completely unrelated to the six months rule, with different requirements and a different rationale. The necessity of payment rule was first enunciated in *Miltenberger* v.

> *Logansport, C. & S.W. Ry. Co.*, 106 U.S. 286, 1 S.Ct. 140, 27 L.Ed. 117 (1882); there it was held that if payment of a claim which arose prior to reorganization is necessary for the continued operation of the railroad during reorganization, (e.g., if a previously unpaid creditor occupies a monopoly position vis-a-vis the railroad during reorganization and threatens to withhold his supplies unless paid) then the trustee is authorized to pay that claim even out of corpus if necessary. The rationale of the rule is that the interests of all parties, including the public and the mortgagees, are best served by the continued operation of the railroad. Diversion is obviously irrelevant to the necessity of payment rule as are also such requirements of the six months rule as reliance on current earnings and accruing of the claim shortly before reorganization. The *Flournoy* court inexplicably merged the two rules by making necessity of payment a requirement of the six months rule and eliminating diversion as a requirement for corpus invasion. This was directly contrary to *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183, 25 S. Ct. 415, 49 L.Ed. 717 (1905), where the Supreme Court in an opinion by Justice Holmes unequivocally held that necessity of payment rule's lack of diversion requirement for corpus invasion was not to be transposed to the six months rule; the former rule, the Court held, was based upon the necessity of payment while the latter rule was based merely on the necessity of the service or supply furnished. 197 U.S. at 187, 25 S.Ct. 415. See also *Taylor* v. *Delaware & E. R. Co.*, 213 F. 622, 624 (2 Cir. 1914).

Id. at 602 n.15.

Hence, it is the clear position of the Courts in the Second Circuit that before priority under the Rule may be accorded there must exist a current debt fund or at least such a diversion of operating revenues for the benefit of mortgagees as justifies recreation of the fund. The Second Circuit has unequivocally inter-

preted this Court's decisions as not permitting invasion of mortgaged property unless a diversion for the benefit of mortgagees has occurred. As noted earlier, any recognition of a priority where no current debt fund exists or can be re-created necessarily requires the invasion of the mortgagees' property. Furthermore, the Courts in the Second Circuit, as do substantially all of the courts which have considered the question, regard *Miltenberger* v. *Logansport C. & S.W. Ry. Co., supra,* as a decision establishing a "necessity of payment" rule that is distinct from, and has absolutely no application to, the Six Months Rule.

Writing for the District Court in *New Haven,* Judge Anderson also succinctly elucidated the Second Circuit's view of depreciation and the propriety of deducting depreciation expense in the determination of the existence and amount of a current debt fund. The surplus earnings required for the current debt fund was defined as the sum of all operating revenues accrued during the aforesaid period which were actually received or taken over by the Trustees, less depreciation and all operating expenses which had actually been paid or were payable by the Trustees or which constituted administration expenses. *Id.* at 599. Depreciation was characterized in the following terms:

> Depreciation . . . does not create additions to assets or accessions to assets already held, but is a reflection of the very real economic fact that the assets are being consumed or wasted away in the process of keeping the railroad running and is actually a measure of the contribution of physical properties made by the mortgagees for this purpose. Therefore, to the extent of depreciation, operations creditors have no equitable claim on operating revenue; they have no equitable right to be protected from the phenomenon of depreciation.

Id. at 604.

As previously noted (see page 9, *supra*) the opinion of the Court of Appeals for the First Circuit fails to address the fundamental equities of the depreciation deduction in terms of the

restitutional nature of the Rule. The above-quoted language of Judge Anderson evidences recognition of those equities by the *New Haven* Court and is certainly in contradiction to the conclusions reached by the First Circuit Court. It may fairly be stated that mortgagees furnish depreciation, the consumption of their security, to the production of current income and in this real sense they are operations creditors to the same extent as are suppliers of necessary goods and services. Accordingly, the withholding from other operation expense creditors of a portion of revenues as a consequence of the deduction for depreciation produces no inequity.

It is apparent from the foregoing that in recognizing a priority under the Six Months Rule simply on the basis of the current furnishing of necessary goods and services in reliance on the railroad's revenues and apparently permitting the payment of that priority *pari passu* with post-petition administration claims from the corpus of the mortgaged property regardless of whether there has been a diversion for the benefit of mortgagees and in holding that depreciation is not deductible in determining the surplus earnings component of the current debt fund, the First Circuit Court's decision is directly *contra* to the law of the Second Circuit.

B. *The Third Circuit*

In *Central R.R. Company of N.J.* v. *Manufacturers Hanover Trust Co.*, 421 F.2d 604 (3d Cir. 1970), the Court of Appeals for the Third Circuit indicated approval of the Second Circuit's position in regard to the necessity of a diversion in favor of mortgagees as a prerequisite to invasion of the corpus of mortgaged property for the purposes of the recognition of a priority for Six Month claims. Although the issue in *Central R.R.* concerned the trustee's removal of funds from the bondholders' account to pay operating expenses, the Court cited *In re New York, N.H. & H. R.R. Co.*, 278 F.Supp. 592 (D. Conn. 1967) as an "excellent discussion of the law regarding creditor priority." 421 F.2d at 608 n.13. The Third Circuit Court, referring to the Six Months Rule and citing Judge Anderson, stated:

> The principle of this priority, however, applies only to operations revenues. Property subject to mortgage liens, or 'corpus'... 'cannot be invaded to satisfy the priority of the operations creditors'... This latter rule does not apply if operations expenses have been 'diverted' to the benefit of the bondholders...

Id.

The Court of Appeals for the Third Circuit therefore concurs with the courts of the Second Circuit in proscribing an invasion of the property rights of mortgage bondholders in absence of a a diversion of current revenues which benefited the bondholders.

The District Court opinion in *In re Penn Central Transp. Co.*, 458 F.Supp. 1234 (E.D. Pa. 1978) directly addresses both issues currently before the Court in the present case. Relying strongly on Judge Anderson's opinion in *In re New York, N.H. & H. R.R. Co.*, 278 F.Supp. 592 (D. Conn. 1967), the *Penn Central* reorganization court held that a current debt fund must exist as a prerequisite to recognition of a priority for Six Months claims, 458 F.Supp. at 1321, and further held that the deduction of depreciation was proper in determining the existence of the current debt fund and did not constitute a diversion in favor of mortgagees. *Id.* at 1324.

Again, the decision below by the Court of Appeals for the First Circuit is clearly *contra* to the law on the issues in the Third Circuit.

C. *The Seventh Circuit*

In *Carbon Fuel Co.* v. *Chicago C. & L. R. Co.*, 202 F. 172 (7th Cir. 1912), the Court of Appeals for the Seventh Circuit interpreted this Court's decision in *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905) as limiting the prior decision in *Miltenberger* to a "necessity of payment" rule as distinguished from a rule establishing a priority. In this respect the Seventh Circuit decision is *contra* to the First Circuit's decision in the case at bar.

D. *The Fourth Circuit*

The Court of Appeals for the Fourth Circuit in *Southern Ry. Co. v. Flournoy*, 301 F.2d 847 851 (4th Cir. 1962), contrary to this Court's decision in *Gregg*, held that a current debt fund is not a prerequisite to recognition of a priority under the Six Months Rule.

II. The Court of Appeals' Decision Below Conflicts With Prior Decisions of This Court Concerning the Six Months Rule

The decision of the Court of Appeals for the First Circuit acknowledged that a priority under the Six Months Rule may be premised on the principle of equitable restitution enunciated by this Court in *Fosdick* v. *Schall*, 99 U.S. 235 (1878), and subsequent cases[14] and that the existence of a current debt fund consisting of either surplus earnings or operating revenues diverted to mortgagees is prerequisite to the recognition of a priority on that basis. (A18, 42). The Petitioners respectfully disagree with the Court of Appeals concerning this basis for application of the Rule only insofar as the Court determined that depreciation should not be deducted from revenue in determining the surplus earnings component of the current debt fund. As previously noted, however, the Court of Appeals further held that a priority is also afforded to pre-reorganization current operating expense claims for necessary current operating expenses furnished on credit in reliance on the railroad's current operating revenue on the same basis and from the same operating income as administration expenses. It appears that a corollary of that holding is that such priority may be paid by invading the corpus of the mortgaged property and impairing the rights of mortgagees in the absence of any diversion for the benefit of mortgagees if there are insufficient operating revenues to pay or provide for those claims and

[14] *See, e.g.*, *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905); *Southern Ry.* v. *Carnegie Steel Co.*, 176 U.S. 257 (1900); *Kneeland* v. *American Loan Co.*, 136 U.S. 89 (1890); *Burnham* v. *Bowen*, 111 U.S. 776 (1884).

all post-petition expenses. It is clear in the case at bar, in light of the estate's substantial operating losses, that recognition of this priority will result in such an invasion and impairment notwithstanding the absence of a net diversion for the benefit of mortgagees. In this respect, the Court's decision is in direct conflict with decisions of this Court that clearly proscribe invasions of the corpus of mortgaged property in the absence of a diversion for the benefit of mortgagees.

In *Fosdick* v. *Schall*, 99 U.S. 235 (1878), this Court first set forth the grounds on which the property rights of mortgagees may be altered to recognize the claims of Six Months creditors.

> The business of all railroad companies is done to a greater or less extent on credit. This credit is longer or shorter, as the necessities of the case require; and when companies become pecuniarily embarrassed, it frequently happens that debts for labor, supplies, equipment, and improvements are permitted to accumulate, in order that bonded interest may be paid and a disastrous foreclosure postponed, if not altogether avoided. In this way the daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses, are kept from those to whom in equity they belong, and used to pay the mortgage debt. The income out of which the mortgage is to be paid is the net income obtained by deducting from the gross earnings what is required for necessary operating and managing expenses, proper equipment and useful improvements. Every railroad mortgagee in accepting his security impliedly agrees that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income. If for the convenience of the moment something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition for such an order that what is due from the earnings to the current debt shall be paid by the court from the future current receipts before anything derived from that source goes to the mortgagees. . .

> We think, also, that if it appears in the progress of the cause that bonded interest has been paid, additional equipment provided, or lasting and valuable improvements made out of earnings which ought in equity to have been employed to keep down debts for labor, supplies, and the like, it is within the power of the court to use the income of the receivership to discharge obligations which, but for the diversion of funds, would have been paid in the ordinary course of business. This, not because the creditors to whom such debts are due have in law a lien upon the mortgaged property or the income, but because, in a sense, the officers of the company are trustees of the earnings for the benefit of the different classes of creditors and the stockholders; and if they give to one class of creditors that which properly belongs to another, the court may, upon an adjustment of the accounts, so use the income which comes into its own hands as, if practicable, to restore the parties to their original equitable rights. . .
>
> *Whatever is done, therefore, must be with a view to a restoration by the mortgage creditors of that which they have thus inequitably obtained. It follows that if there has been in reality no diversion, there can be no restoration; and that the amount of restoration should be made to depend upon the amount of the diversion.*

Id. at 252-54 (emphasis added). The Court in *Fosdick* clearly states that payment to current expense creditors shall not be in derogation of the rights of the secured bondholders unless such bondholders actually received something which properly belonged to the current expense creditors.

Again, in *Kneeland* v. *American Loan and Trust Co.*, 136 U.S. 89 (1890), a case in which payment for rolling stock was sought as a priority ahead of the pre-existing rights of mortgagees, and a case in which neither a surplus of current earnings nor a diversion of funds for the benefit of mortgagees existed, this Court stated:

> Because in a few specified and limited cases this court has declared that unsecured claims were entitled to priority over mortgage debts, an idea seems to have obtained that a court appointing a receiver acquires power to give such preference to any general and unsecured claims. . . . One holding a mortgage debt upon a railroad has the same right to demand and expect of the court respect for his vested and contracted priority as the holder of a mortgage on a farm or lot. So, when a court appoints a receiver of railroad property, it has no right to make that receivership conditional on the payment of other than those few unsecured claims which, by the rulings of this court, have been declared to have an equitable priority. *No one is bound to sell to a railroad company or to work for it, and whoever has dealings with a company whose property is mortgaged must be assumed to have dealt with it on the faith of its personal responsibility, and not in expectation of subsequently displacing the priority of the mortgage liens. It is the exception and not the rule that such priority of liens can be displaced. We emphasize this fact of the sacredness of contract liens, for the reason that there seems to be growing an idea, that the chancellor, in the exercise of his equitable powers, has unlimited discretion in this matter of the displacement of vested liens.*

Id. at 97-98 (emphasis added).

In holding that additional grounds existed apart from the principle of equitable restitution for according a priority to Six Months claimants, the First Circuit relied heavily on this Court's decision in *Miltenberger* v. *Logansport C. & S.W. Ry. Co.*, 106 U.S. 286 (1882). In this regard the Court of Appeals seriously misinterpreted the *Miltenberger* decision and is in conflict with this Court's decision in *Gregg* v. *Metropolitan Trust Company*, 197 U.S. 183 (1905). Indeed, the Court of Appeals' interpretation and application of *Miltenberger* is substantially the same as that

contained in a prior decision of the First Circuit which was later explicitly repudiated by this Court in *Gregg*.

As the Court of Appeals itself noted (A19), the critical issue in *Miltenberger* was the court's authorization of capital expenditures and financing of these expenditures by receiver's certificates secured by a lien which primed the first mortgage. The lesser aspect of the case involved a belated challenge by certain first mortgage bondholders to the receiver's payment, previously authorized by the Court, of certain pre-receivership expenses, payment of which the receiver believed to be indispensable to the continued operation of the railroad. In affirming the lower court's approval of such payments, the *Miltenberger* Court stated:

> Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay pre-existing debts of certain classes, out of the earnings of the receivership, or even the corpus of the property, under the order of the court, with a priority of lien. Yet the discretion to do so should be exercised with very great care. The payment of such debts stands, prima facie, on a different basis from the payment of claims arising under the receivership, while it may be brought within the principle of the latter by special circumstances. It is easy to see that the payment of unpaid debts for operating expenses, accrued within ninety days, due by a railroad company suddenly deprived of the control of its property, due to operatives in its employ, whose cessation from work simultaneously is to be deprecated, in the interests both of the property and of the public, and the payment of limited amounts due to other and connecting lines of road for materials and repairs for unpaid ticket and freight balances, *the outcome of indispensable business relations, where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment*, the general consequences involving largely, also, the interests and accommodation of travel and traffic, may

> well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and entitle them to be made a first lien. This view of the public interest in such a highway for public use as a railroad is, as bearing on the maintenance and use of its franchises and property in the hands of a receiver, with a view to public convenience, was the subject of approval by this court, speaking through Mr. Justice Woods, in *Barton* v. *Barbour*, 104 U.S. 126. The appellants furnish no basis for questioning any specific amounts allowed in respect of the arrears referred to, but object to the allowance of anything out of the sale of the corpus for such expenditures. Under all the circumstances of this case, we see no valid objection to the provisions of the orders complained of.

Id. at 311-12 (emphasis added).

The Court of Appeals in the decision below has shifted the focus of *Miltenberger* from the necessity of payment by a receiver in order to keep the railroad operating to the granting of a priority to suppliers of necessary services. (A36, 37). This interpretation of *Miltenberger* by the Court of Appeals is substantially the same as that posited in a prior decision of the First Circuit in *New England R.R. Co.* v. *Carnegie Steel Co.*, 75 F.54 (1896). In *New England R.R.*, the First Circuit approved payment of a pre-receivership supply claim out of the corpus of mortgaged property on the authority of *Miltenberger*, stating:

> Whatever might be our decision if the case was of novel impression, we think we are concluded by Miltenberger v. Railway Co., 106 U.S. 286, 292, 293, 295, 298, 302, 304, 308, 311, 1 Sup. Ct. 140, as explained, and perhaps limited, in Kneeland v. Trust Co., 136 U.S. 89, 96, 97, 10 Sup. Ct. 950; Thomas v. Car Co., 149 U.S. 95, 110, 112, 13 Sup. Ct. 824; Bound v. Railway Co., 7 C. C. A. 332, 58 Fed. 473, 480; and Finance Co. of Pennsylvania v. Charleston, C. & C. R. Co., 10 C.C.A. 323, 62 Fed. 205, 208. We are

> therefore required to hold that the circuit court had the power to give the priority complained of to supply bills of the charter, contracted at the time, and remaining unpaid, under the circumstances shown in reference to those now at issue. What would have been the conclusion if the trustees of the second mortgage had not asked for a receiver, and had not submitted to the order of September 8, 1894, modifying to some extent the then existing receivership, and thus giving it retroactive effect as of the time of its original creation, we need not determine. So far as we have discovered, Miltenberger v. Railway Co. is the only instance in which the supreme court has in fact allowed accrued supply bills a priority against the corpus of mortgaged property; and, as we understand that suit, the circumstances of the case at bar in its final stages are substantially the same for our present purposes, and we have followed strictly its conclusions without going beyond them.

Id. at 59.

This earlier interpretation of *Miltenberger* (which is apparently the interpretation adopted in the decision which is the subject of this Petition) was specifically repudiated by this Court in *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183, 187 (1905). In *Gregg*, a pre-receivership supplier of railroad ties sought to be paid out of the proceeds of mortgaged property in the hands of the receiver. The claimant argued that a diversion for the benefit of the mortgagees was not a prerequisite to his prior right in the proceeds of sale of the mortgaged property and cited *Miltenberger* in support of his position. In fact, there was no diversion for the benefit of mortgagees. The supplier's claim was denied by the Court, and *Miltenberger* was distinguished as a case justifying payment of a pre-receivership supplier not because he was a current supplier of necessary goods or services, but because the payment of the pre-receivership obligation was necessary if the receivers were to continue the business.

This Court stated:

> The case stands as one in which there has been no diversion of income by which the mortgagees have profited, or otherwise, and the main question is the general one, whether in such a case a claim for necessary supplies furnished within six months before the receiver was appointed, should be charged on the corpus of the fund. There are no special circumstances affecting the claim as a whole, and *if it is charged on the corpus it can be only by laying down a general rule that such claims for supplies are entitled to precedence over a lien expressly created by a mortgage* recorded before the contracts for supplies were made. An impression that such a general rule was to be deduced from the decisions of this court led to an evidently unwilling application of it in *New England R. Co.* v. *Carnegie Steel Co.*, 75 Fed. Rep. 54, 58, and perhaps in other cases. *But we are of opinion*, for reasons that need no further statement, *Kneeland* v. *American Loan & Trust Co.*, 136 U.S. 89, 97, *that the general rule is the other way*, and has been recognized as being the other way by this court.
>
> The case principally relied on for giving priority to the claim for supplies is *Miltenberger* v. *Logansport &c. Railway Co.* (sic), 106 U.S. 286. But while the payment of some preexisting claims was sanctioned in that case, it was expressly stated that "the payment of such debts stands, *prima facie*, on a different basis from the payment of claims arising under the receivership." *The ground of such allowance as was made was not merely that the supplies were necessary for the preservation of the road, but the payment was necessary to the business of the road—a very different proposition.* In the later cases the wholly exceptional char cter of the allowance is observed and marked. *Kneeland* v. *American Loan & Trust Co.*, 136 U.S. 89, 97, 98. *Thomas* v. *Western Car Co.*, 149 U.S. 95, 110, 111; *Virginia & Alabama Coal Co.*, v. *Central Railroad & Banking Co.*, 170 U.S. 255, 370.

197 U.S. at 186-87 (emphasis added).

The foregoing language makes explicit that neither in *Miltenberger* nor in any other case did this Court premise a priority for pre-petition operation expense on anything but the equitable restitutional basis which requires either surplus operating income after the payment of all expenses or a diversion for the benefit of mortagees which alone justifies an impairment of the mortgagees' property rights. As a consequence of this Court's teaching in *Gregg*, the rule of the *Miltenberger* decision has since become known as the "Necessity of Payment Rule", and has generally been treated as separate and distinct from the Six Months Rule. *See, e.g., In re New York, N.H. & H.R.R. Co.*, 278 F.Supp. 592, 602 n.15 (D. Conn. 1967) (reprinted *supra*, pp. 12-13); Note *The Present Status of the Six Months Rule*, 34 Colum. L. Rev. 230, 234 n.11 (1937); Note, *Bankruptcy Law — The Continued Vitality of the Six Months Rule in Railroad Receiverships*, 57 N.C.L. Rev. 137, 140 n.30 (1978). Indeed, the First Circuit in the present case recognized the Necessity of Payment Rule as distinct from the Six Months Rule, but failed to cite *Miltenberger*, or any other authority, as the basis of that rule. (A45). The Court of Appeals' utilization of *Miltenberger* as an alternate basis for operation of the Six Months Rule is directly *contra* to this Court's opinion in *Gregg*. Inasmuch as *Gregg* represents the last major discourse on the Rule by the Supreme Court, intervening authority to support the First Circuit Court's conception of the Rule does not exist.

III. The Court of Appeals' Decision Below Conflicts With Congressional Policy as Recently Reflected in the Adoption of the Railroad Reorganization Provisions of the Bankruptcy Reform Act of 1978.

The Court of Appeals' determination that a priority may be accorded to Six Months claimants on the *Miltenberger* receivership-administration principle is premised on a view of Six Months claims as being no different from administration expense claims and also no different from similar current operating

claims actually paid in the ordinary course on the eve of reorganization.[15] Believing that there should be equality of treatment between administration expenses and Six Months claims notwithstanding the filing of the reorganization petition, the Court stated:

> That equality is readily achieved by recognizing administration expenses as extending backward to the period preceding reorganization to the extent necessary to assure that there is continuity in the payment of indispensable operating expenses without reference to the date the petition is filed so long as the current expenses of the pre-reorganization period that are brought forward for payment conform to the strict standard established for administration expenses of the current operating class, and are not so dated as to forbid the conclusion that they are in fact current. The inequity in treatment arising out of the accidental circumstance of non-payment before the filing of the petition is eliminated.

(A39).

Interestingly enough, both the attempt to void the consequences of the filing of the reorganization petition and the First Circuit Court's interpretation of the priority were recommended by the Commission on the Bankruptcy Laws of the United States in its 1973 report and recommendations for revision of the bankruptcy laws submitted to the President, the Chief Justice and the Congress. In its Report, the Commission proposed that as a prerequisite to confirmation of any plan of railroad reorganization, the court must find that:

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[15] The Court of Appeals erroneously assumed that such actual payments are necessarily not preferential in nature and therefore concluded based on that erroneous assumption that the nonpayment of other like expenses involved inequality of treatment. (A39). In fact, the payment on the eve of bankruptcy of previously arising claims is preferential both under Section 60 of the Act and Section 547 of the Bankruptcy Code and, depending on the circumstances, may be a voidable preference.

> in addition to providing for payment of all amounts required pursuant to section 7-303(2), the plan provides for payment of all allowed claims for current operating expenses incurred by the debtor during the six months immediately preceding the filing of the petition.

Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, 93rd Cong., 1st Sess. 288 (1973), *reprinted in, Collier on Bankruptcy*, Appendix, Vol 2 (15th Ed. 1980). Pursuant to the Commission's recommendation, the Senate bill proposed a requirement that any confirmed plan

> provides the priority traditionally accorded by section 77(b) to claims by rail creditors for necessary services rendered during the six months preceding the filing of the petition in bankruptcy.

S. Rep. No. 95-989, 95th Cong., 2d Sess. 136, *reprinted in, Collier on Bankruptcy*, Appendix, Vol. 3 (15th Ed. 1980). The House version of the proposed legislation, however, did not require the recognition of all six month operating expenses as priorities as a prerequisite to confirmation. H.R. 8200 simply recognized as priorities those claims that would have been entitled to priority in a federal equity receivership—essentially leaving the law as it existed under the Bankruptcy Act unchanged. The House version of the legislation was ultimately enacted as section 1171(b) of the Bankruptcy Reform Act of 1978.

This legislative history is significant in that it reflects congressional rejection of an automatic priority for operations creditors who supplied necessary goods and services during the six months preceding the filing of the reorganization petition. Obviously, the drafters of the Reform Act were aware of the limitations imposed by this Court and others on the recognition of a priority under the Six Months Rule. Inasmuch as the decision of the Court of Appeals in the case at bar recognizes an automatic priority for Six Months claims on the same basis and from the

same source as administration expenses, it directly conflicts with this recent statement of congressional policy.

IV. The Present Case Offers An Excellent Opportunity to Eliminate Disagreement Among the Circuits and Continually Recurring Disputes Regarding the Applicability of the Six Months Rule.

In the face of a number of pending railroad reorganization proceedings and the likelihood of future proceedings, all of which will confront the questions herein presented regarding application of the Rule, the Court should avail itself of the opportunity to finally resolve these questions. The questions presented are of national significance and require a determination by the Court both because application of the Rule has a substantial economic impact upon virtually all railroad reorganizations and because differing applications of the Rule may well work substantial inequities.

Because of the nature of the railroad industry, there is a high incidence of mutuality of claims between railroads, including railroads in reorganization proceedings. The Penn Central has claims against the Boston and Maine and the latter has claims against the Penn Central. Likewise, mutual claims exist between the Boston and Maine and other roads in reorganization. If the decision of the Court of Appeals for the First Circuit becomes final, a portion of the claims of such railroad creditors of the Boston and Maine may be entitled to a priority under the Six-Months Rule while no similar treatment is accorded to the claims of the Boston and Maine in the reorganization proceedings of those railroad creditors under the holdings of the Courts in their Circuits. It is by no means clear that the principle of set-off will operate to correct the obvious inequity. We respectfully submit that such inequity, the confusion resulting from differing views of the Circuits, and future litigation may best be avoided by the resolution by this Court of the questions presented on this Petition.

This case offers an excellent opportunity for the Court to address and clarify the parameters and requirements of the Six

Months Rule. The issues are precise and no questions are presented concerning the special nature of specific claims or the propriety of inclusion of specific claims within any priority classification.

As noted by the District Court in *In re Third Ave. Transit Corp.*, 138 F.Supp. 623 (S.D.N.Y. 1955), *aff'd per curiam*, 230 F.2d 425 (2d Cir. 1956), the history and application of the Rule has been, at best, inconsistent.

> The researches of counsel supplemented by such research as has been at my command have not resulted in the discovery of any principle by which would account for all of the decisions so that one might say there was a principle behind them.

Id. at 625. Although the Petitioners herein do not concur with the above-quoted passage but rather posit that a clear principle does indeed exist, the inconsistent statements and rulings of various courts on the issues reflect substantial confusion among the lower courts.

It is important to note that this Court has not addressed the Six Months Rule since the adoption of the railroad reorganization provisions of Section 77 of the Act. Thus, the present case also offers an excellent opportunity for the Court to determine whether recognition of a priority for Six Months claims is indeed beneficial or detrimental to the interests of the public in the present circumstances. Although the Respondents suggest that one of the purposes of the Rule is to ensure continued supply of necessary goods and services to maintain operation of the road, it has been observed that continued extensions of credit all too often delay necessary reorganization to the point where the road's assets are so depleted as to make reorganization a monumental task at best — to the detriment of both the public and the creditors of the road. *See, e.g., In re New York, N.H & H.R.R. Co.*, 278 F.Supp. 592, 606 (D. Conn. 1967); Comment, 33 Colum. L. Rev. 834, 850 (1933). Additionally, such an all-encompassing priority as would be recognized by the First Circuit Court may well discourage necessary mortgage financing.

Conclusion

The present case presents an excellent opportunity for the Court to resolve the significant and recurring issues presented herein. The decision below clearly conflicts with decisions rendered both by this Court and by other Circuit Courts of Appeals and is contrary to congressional policy. The issues presented are straight-forward and devoid of collateral issues and therefore the case is an excellent vehicle for a conclusive judicial statement on the questions presented.

For each of the foregoing reasons, the Petitioners respectfully pray that a writ of certiorari be granted as herein requested.

Respectfully submitted,

THE FIRST NATIONAL BANK OF BOSTON AND MALCOLM W. HALL, Successor Indenture Trustees

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APPENDIX A

United States Court of Appeals
For the First Circuit

No. 79-1230

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

CHESAPEAKE AND OHIO RAILWAY COMPANY, ET AL.,
APPELLANTS.

No. 79-1231

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

MAINE CENTRAL RAILROAD COMPANY, ET AL.,
APPELLANTS.

No. 79-1234

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

PENN CENTRAL CORPORATION,
APPELLANT.

No. 79-1235

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

CANADIAN PACIFIC,
APPELLANT.

No. 79-1236

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

EASTERN ASSOCIATED COAL CORPORATION,
APPELLANT.

APPEALS FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS
[HON. FRANK J. MURRAY, *Judge*]

Before
KUNZIG,* *Judge, U.S. Court of Claims*
BOWNES, *Circuit Judge*
DOOLING,** *Senior District Judge*

Entered October 6, 1980

John T. Collins, with whom *Sherburne, Powers & Needham* was on brief, for Chesapeake and Ohio Railway Company, Baltimore and Ohio Railway Company and Western Maryland Railway, appellants.

Paul B. Galvani, with whom *Reed Witherby* and *Ropes & Gray* were on brief, for Maine Central Railroad Company and Portland Terminal Company, Appellants.

George W. McLaughlin for Canadian Pacific, appellant.

Philip Burling, with whom *Peter A. Fine* and *Foley, Hoag & Eliot* were on brief, for Eastern Associated Coal Corporation, appellant.

Robert M. Gargill, with whom *Zdislaw W. Wieckowski, Choate, Hall & Stewart*, and *Charles W. Mulcahy* were on brief, for the Trustees of the Boston and Maine Corporation, Debtor, appellees.

Joseph H.B. Edward, with whom *Bingham, Dana & Gould* was on brief, for the First National Bank of Boston and Malcolm W. Hall Successor Trustees, under First Mortgage Indenture Dated December 1, 1919 of Boston and Maine Corporation, appellees.

* Sitting by designation.
** Of the Eastern District of New York, sitting by designation.

DOOLING, D.J.

The present appeals[1] in this railroad reorganization case challenge the district court's order, 468 F. Supp. 996 (D. Mass. 1979), determining the priorities of the creditors and stockholders in the reorganization of the Boston and Maine Corporation. Railroads which, as required by the Interstate Commerce Act and the cases decided under it, have interlined freight cars with the Boston & Maine appeal from the district court's refusal to accord their claims for per diem charges for cars furnished in the periods August 1, 1953, to July 31, 1969, and August 1, 1969, to March 12, 1970, such a priority in the classification of creditors as would assure full payment of the claims. The interlining railroads and Eastern Associated Coal Corporation appeal also from the district court's refusal to establish a separate class of creditors, to be accorded priority as "six months creditors," for the railroads' claims for per diem car hire, car repair, loss and damage, and freight overcharges for the six months preceding the filing of the involuntary petition against the Boston and Maine on March 12, 1970, and for the Coal Corporation's claim for diesel fuel furnished in the same six months period.

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[1] The appeals of the Committee of Interline Railroads and of Trailer Train Co. have been withdrawn. No briefs have been submitted in support of the appeals of Penn Central Transportation Company and Atchison, Topeka and Sante Fe Ry. The appeals of the Chesapeake and Ohio Railway Company, et al., and of Canadian Pacific present the issues concerning the classification of the per diem claims of the interlining railroads for the period August 1, 1953, through July 31, 1969, as well as of the railroads' claims for per diem car hire, car repairs and loss and damage for the six months preceding the date on which the involuntary petition was filed against the Boston and Maine. The appeals of Maine Central Railroad Company and Portland Terminal Company and of Eastern Associated Coal Corporation relate to the classification of claims for per diem car hire, freight loss and damage and overcharge, car repairs, and diesel fuel for the six months preceding the filing of the petition.

I

The railroads' per diem claims, aggregating $8,582,000, are described in Chief Judge Coffin's opinion for this court, 600 F.2d 307 (1st Cir. 1979), affirming the district court's refusal, 456 F. Supp. 412 (D. Mass. 1978), to order immediate payment of the per diem charges before payment of all other unsecured pre-reorganization claims.[2] On that appeal this court rejected the contention that because the trustees' operation of the Boston and Maine is subject to the jurisdiction of the Interstate Commerce Commission, *see* former Bankruptcy Act § 77(c)(2), 11 U.S.C. § 205(c)(2) (1976), and because the ICC has ordered payment of specific per diem rates at specific settlement times, neither the trustees nor the court have discretion to defer payment of the pre-petition per diem charges. 600 F.2d at 308. This court concluded that the ICC had not exercised its statutory power, 49 U.S.C. § 1(14)(a) (1976), to fix the rates for per diem settlements for the period August 1, 1953, to August 1, 1969, and that, so far as concerned the period after August 1, 1969, following the ICC's entry of a per diem rate order, the general power of the ICC to supervise the trustees' operation of the railroad did not outweigh the fundamental power of the reorganization court to set priorities for payment of pre-reorganization claims, Bankruptcy Act §§ 77(b), (c)(7), (l), and to schedule payment of such claims consistent with the need to conserve assets for rehabilitation of the debtor. 600 F.2d at 309-10. The court added that the 1968 ICC order that interlining railroads pay specific per diem charges, *Chicago, B. & Q. R.R.* v. *New York, S. & W. R.R.*, 332 I.C.C. 176, 241, 333 (1968), was an order of general application, and that, since non-payment of the per diem claims violated no specific order directed to the reorganization trustees, the remedial provisions of Section 1(17)(a) of the

[2] The district court decision recounts the sequence of proceedings leading to the ICC's fixing of per diem rates in 1968. *See* 456 F. Supp. at 413 n.2.

Interstate Commerce Act[3] could not be invoked. 600 F.2d at 312. The court observed that, fundamentally, the specific duty to pay the per diem charges due for the pre-reorganization period had been a duty of the railroad, and, after the filing of the petition, those charges became claims against the debtor, not claims against the trustees; the specific duty of the trustees, as operators of the railroad, to pay per diems was limited to the per diems incurred by the trustees in their operation of the road.[4] The court rejected the contrary reasoning of *In re Chicago, R.I. & P.R.R.*, 537 F.2d 906 (7th Cir. 1976), *cert. denied*, 429 U.S. 1092 (1977), and indicated agreement with the result reached in *In re Penn Central Transportation Co.*, 486 F.2d 519 (3rd Cir. 1973), *cert. denied*, 415 U.S. 990 (1974), and which the Third Circuit reaffirmed in the different circumstances of *In re Penn Central Transportation Co.*, 553 F.2d 12 (3rd Cir. 1977). *See* 600 F.2d at 310-12.

On this appeal the interlining railroads argue, first, that since the interlining of freight cars is mandatory under the Interstate Commerce Act, 49 U.S.C. §§ 1(4), (10), (11), (14), (15), and (17), equity and considerations of national transportation policy unite to require that the roads receive just and reasonable compensation for the compelled loan of freight

[3] 19 U.S.C. § 1(17)(a) provides that if "any carrier, receiver, or operating trustee" fails or refuses to comply with any order or direction of the ICC as to car service it shall be liable to stated penalties, recoverable in a civil action brought by the United States. Citations are to the Interstate Commerce Act, as amended, 49 U.S.C. § 1, *et seq.* (1976). Parallel sections respecting car service are now comprised in 49 U.S.C. § 11121, *et seq.*

[4] The court found in the terms of the Bankruptcy Reform Act provision, 11 U.S.C. § 1166, a resolution of any supposed contradiction between Section 77(c)(2) and Section 77 (1) in the requirement that both the ICC and the reorganization court approve payment for both pre- and post-reorganization per diem charges. The Congress in adopting Section 1166 rejected a Senate provision requiring the debtor to pay in cash current balances owed other carriers for interlining charges, including incentive per diems, for periods both before and after the filing of the petition.

cars; it is argued that the rail car fleet cannot be maintained at the level essential to adequate rail service unless payment of car hire is assured even in the case of the railroads that are in reorganization. The argument is essentially that made on the earlier appeal, and, so far as concerns the per diem claims for the period 1953 to August 1, 1969, is disposed of by what was then decided: the per diem claims for that sixteen year period were not based on an ICC order fixing rates and ordering payment at those rates; the ICC in *Chicago, B. & Q.R.R.* v. *New York, S. & W.R.R.*, 332 I.C.C. 176, 183, 244-57 (1968),[5] did, indeed, make findings as to the reasonableness of the rates charged for the preceding fifteen years, but those findings, it stated, were "of significance only as an aid to the courts in settling the amount of damages in the pending lawsuits" (*id.* at 183).[6]

The unpaid per diem charges for car use during the period August 1, 1969, to March 12, 1970, the date on which the reorganization proceeding commenced, aggregated $564,000; they were imposed at the rate determined by the order of the ICC, *Chicago, B. & Q. R.R.* v. *New York, S. & W. R.R.*, *supra*, 332 I.C.C. at 259; that order became final upon the Supreme Court's affirmance of the district court decisions

[5] The background and course of the litigation are outlined in the district court's decision in the "immediate payment" case, *In re Boston & Maine Corp.*, 456 F. Supp. at 413 n.2.

[6] In the suit to recover from the Boston & Maine and other railroads the difference between the amounts paid and the higher charges fixed by the Association of American Railroads, the district court deferred to the ICC's determination of the reasonableness of the AAR rates. *Baltimore & O. R.R.* v. *N.Y., N.H. & H. R.R. Co.*, 196 F. Supp. 724, 748-49 (S.D.N.Y. 1961). The ICC decision, *Chicago, B. & Q. R.R.* v. *New York, S.&W. R.R.*, 332 I.C.C. 176 (1968), fixing rates for the period commencing October 1, 1968, and making findings on the reasonableness of the rates for the 1953-1968 period, was sustained, *Boston & M. R.R.* v. *United States*, 297 F. Supp. 615 (D. Mass.), and *Union Pacific R.R.* v. *United States*, 300 F. Supp. 318 (D. Neb.), both *aff'd., without opinion*, 396 U.S. 27 (1969).

dismissing the railroads' actions to set the order aside,[7] and it was made effective August 1, 1969. This court's decision on the earlier appeal is dispositive of all the contentions raised on the present appeal as to this portion of the per diem claims except the constitutional argument. While Chief Judge Coffin's opinion was occasioned by the "immediate payment" contention of the railroads, it dealt directly and necessarily with the underlying issues of statutory interpretation and with the contention that a priority in reorganization for per diem claims would, by furnishing to the railroads an incentive for overcoming the chronic shortage of freight cars, better serve the interest of national transportation policy than would denying the priority in the interest of preserving the public service viability of bankrupt roads.

The railroads argue, on the constitutional issue, that since Congress has mandated the interline loan of cars and the ICC has fixed the per diem rates to be paid for the cars lent, denying to the car-owning railroads such a priority as will assure payment of the per diem claims in reorganization effects a taking of their property without due process of law, an unconstitutional taking akin to that found in *Chicago, R.I., & P. Ry.* v. *United States*, 284 U.S. 80, 96-100 (1931); there a divided court invalidated that part of the ICC order in *Rules for Car-hire Settlement*, 160 I.C.C. 369, 386-395, 445 (1930), that granted to the short line railroads two days of free time for interchanged loaded cars and denied compensation altogether in the case of cars received for return loading with coal from mines customarily dependent upon connecting carriers for car supply. The Court put the decision on the ground that, since the ICC had found that the owning roads were entitled to receive reasonable compensation in the form of a daily rental for the use of their general-service freight cars when on foreign lines, and that the $1 per car day charge then in effect was such reasonable compensation, the ICC could not,

[7] *See* note 6.

without inconsistency, relieve one class of railroads of the duty to pay that reasonable compensation: "The use of railroad property is subject to public regulation, but a regulation which is so arbitrary and unreasonable as to become an infringement upon the right of ownership constitutes a violation of the due process of law clause of the Fifth Amendment." 284 U.S. at 97.[8]

The rule, thus condemned by its very terms, effected at least a partial denial of compensation for car use in every instance of an interchange of cars between trunk line and short line. However, the failure to accord a special priority in reorganization to per diem claims neither denies an entitlement nor takes either property or its use without compensation. It is rather a refusal, on a ground of statutory policy, to confer on per diem charges the special advantage of freedom from one commercial risk, the risk of becoming an unsecured claim in reorganization. Whatever might be the case if interchange of cars was enforced in circumstances in which there was certainty of non-payment, it is not the case that a scheme of regulation that effects an appropriate public purpose may not, without violation of constitutional principle, entail random losses due to extrinsic factors. *See Baltimore & O. R.R.* v. *United States*, 345 U.S. 146, 148 (1953) (carload rates on certain kinds of fresh vegetables not violative of due process *merely* because they are noncompensatory; so long as regulations do not cause railroad to lose money on its overall business "it is hard to think that it could successfully charge

[8] The railroads also cite *Chicago, M. & St. P.R.R.* v. *Wisconsin*, 238 U.S. 491 (1915), in which the Court invalidated a Wisconsin law which provided that whenever a person engaged a lower berth in a sleeping car and the upper berth in the same section was neither engaged nor occupied, the upper berth should not be let down but should remain closed until engaged or occupied. The divided court held that the statute was not a reasonable exercise of state police power but a taking of property without compensation. The statute, like the short line rule, mandated a transfer of a value without compensation in money or justifying social value.

that its property was being taken for public use without just compensation");[9] *Indiana Harbor Belt R.R.* v. *United States*, 510 F.2d 644, 650 (7th Cir.) (ICC order requiring belt line to move empty cars to repair shops without charge not an unconstitutional taking of property without just compensation absent a showing as to belt line's overall operations), *cert. denied*, 422 U.S. 1042 (1975); *Western Air Lines, Inc.* v. *CAB*, 495 F.2d 145, 152-153 (D.C. Cir. 1974) (Board's denial of operating certificate to carrier that sought to operate only over profitable routes justified by consideration that supra-competitive profits of a single carrier already serving the route would enable it to undertake unprofitable local service that required such subsidization).

The railroads' contention must be considered strictly in terms of the necessary impact of the rules for car-hire settlement in the case of per diem claims against railroads in reorganization. But no extension of credit to insolvent railroads is inherent in the rules for car-hire settlement; the Commission in *Rules for Car-hire Settlement, supra,*[10] approved the rule of the "car service and per diem agreement" among the subscribing railroads which required that the car owner be furnished with a per diem statement within forty days after the end of each calendar month giving the number of days each car has been in the possession of the reporting road; the Commission noted that customarily the car owner, upon receipt of that information, drew on the using line for the amount reported after deducting per diems, if any, owed

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[9] *Government of Guam* v. *FMC*, 329 F.2d 251, 254 (D.C. Cir. 1964), and *Pan American World Airways, Inc.* v. *CAB*, 256 F.2d 711 (D.C. Cir. 1958), reach the same result on parallel facts. *Government of Guam* spoke of the result as deriving from "the compelling obligation of the carrier to render public service."

[10] An order giving effect to the findings of *Rules for Car-hire Settlement* was entered in *Rules for Car-hire Settlement*, 165 I.C.C. 495 (1930), *aff'd in part, reversed in part, Chicago, R.I. & P. Ry.* v. *United States*, 284 U.S. 80 (1931).

the other carrier. The accumulation of charges beyond the forty days was the product of the interminable controversy over rates, not a necessary consequence of interlining freight cars; the modest credit term implicit in the car-hire settlement rules could hardly be much shortened, and, given the importance of interchanging cars to the owning railroads' earning of freight revenue, the credit risk involved is not different from that generally incident to the conduct of industrial and commercial business. That some per diems of such short date may go unpaid in some railroad reorganizations, and that the loan of cars is required by law, do not combine to show a taking without just compensation. What must be shown to demonstrate unconstitutionality, and is not shown, is that the regulatory scheme as a whole, not excluding the incidence of the loss in reorganization cases arising from the extensions of credit required by the settlement rules, operates to take the property of the car-owning roads without just compensation, or is so unreasonable or arbitrary that it violates due process. The interline car-service rules and practices have evolved pragmatically in reasoned stages with but one only partly successful constitutional challenge (*Chicago, R.I. & P. Ry.* v. *United States, supra*) from the beginning position that a railroad could refuse to send its cars beyond its line when there was a car shortage since its first duty was to the business of its line, *Riddle, Dean & Co.* v. *Pittsburgh & Lake Erie R.R.*, 1 I.C.C. 374, 388 (1888); through the critical decision that local traffic does not enjoy rights superior to through traffic and that carriers must make reasonable rules and regulations with respect to the operation of through routes and the exchange, interchange and return of cars used on these routes, *Missouri & Illinois Coal Co.* v. *Illinois Central R.R.*, 22 I.C.C. 39, 48-49 (1911); to the later comprehensive ICC review and implementation of general car service standards in *Rules for Car-hire Settlement, supra*, and the succession of ICC orders of more recent years. In *Chicago, B. & Q. R.R.* v.

New York, S. & W. R.R., 332 I.C.C. 176 (1968),[11] the Commission, accepting the concept that car hire should be enough reasonably to compensate the owner for its costs of ownership and no more,[12] concluded that per diem charges should constitute no more than a sharing of cost, and should not include any amount for the value of the use of a car. *Id.* at 186-87.[13]

Bad debt losses of the car-owning railroads in rail reorganizations are simply elements of cost incident to the massive system of interchanging freight cars, and unless the system as a whole is shown to burden the car-owning railroads unreasonably or arbitrarily or to deny them overall reasonable compensation for the mandated loan of their cars, there is no transgression of constitutional right. No such showing was attempted, nor is it suggested that it could be made.

II

The claims for which priority is asserted under the "Six Months Rule" do not exceed $3,000,000 and include per diems for the period commencing September 13, 1969; priority is also claimed for the greater part of the same claims under the "Necessity of Payment" rule, but for some $400,000 of claims priority is sought under the Necessity of Payment rule only.

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[11] For the history of the ICC decision *see* note 6, *supra*.

[12] *Boston & Maine R.R.* v. *United States*, 162 F. Supp. 289, 295 (D. Mass.), *appeal dismissed*, 358 U.S. 68 (1958), is to the same effect.

[13] More recent decisions have sustained further ICC action respecting interchange of cars. *United States* v. *Allegheny-Ludlum Steel Corp.*, 406 U.S. 742 (1972), approved as reasonable under Section 1(14)(a) two car service rules promulgated in 1969 by the Commission which required freight cars, after being unloaded, to be returned in the direction of the lines of the road owning the cars. The Court, reviewing the car service history of the railroads, said that, "The freight cars of the Nation thus became in essence a common pool, used by all roads." *Id.* at 743. And in *Ann Arbor R.R.* v. *United States*, 368 F. Supp. 101, 112-13 (E.D. Pa. 1973), *aff'd without opinion*, 419 U.S. 807 (1974), the courts sustained the Commission's incentive per diem rules under the 1966 amendment to Section 1(14)(a).

The district court held that to establish a priority under the Six Months Rule the creditor had to show that its claim was for a necessarily incurred current operating expense of the railroad, that it accrued within the six months preceding the filing of the reorganization petition, and that the goods or services were furnished in the expectation of payment from current railway operating revenues and not in reliance on the railroad's general credit. 468 F. Supp. at 1002. The court held further that the creditor had to show that there existed a fund in which qualifying six months claims would have a priority, that is, a "current debt (or expense) fund" comprised of current earnings of the six months period and during the reorganization or, absent a surplus of such earnings, corpus of the reorganization estate to the extent that such earnings have been diverted to it for the benefit of the railroad's mortgagees.[14] *Id.* at 1002-1005. The court concluded from the evidence that, treating depreciation as properly deductible in determining the amount of surplus earnings available for a "current debt fund," no surplus revenues had accrued either in the six months preceding the filing of the reorganization petition or during the reorganization proceeding; that, in addition, contributions to railway operating income and to the reduction of railway operating expenses had been made from the proceeds of sales of mortgaged property and from sales of scrap derived from mortgaged property; and that, finally, even if the net railway operating deficit for the relevant period, $42.5 million, were reduced by disallowing capital expenditures for property and improvements of $12.9 million, payments of pre-reorganization secured obligations of $5.6

[14] The district court held that Six Months Rule creditors were not entitled to a priority in unmortgaged assets; the court declined to follow dicta indicating a contrary assumption in *In re New York, N.H. & H. R.R.*, 278 F. Supp. 592, 598 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969), and in *In re Penn Central Transp. Co.*, 458 F. Supp. 1234, 1321 n. 81 (E.D. Pa. 1978). 468 F. Supp. at 1007-08.

million, and estimated six months claims of $3 million, there would remain a net railway operating deficit of $21 million and an adjusted deficit in income available for fixed charges of $11.7 million. *Id.* at 1005-07. The district court rejected the claim for priority under the "Necessity of Payment" rule on the ground that the rule was not one of priority but of payment, and that it is inapplicable where, as in the present case, no creditor claiming under the rule had demanded payment of its claim as a condition to providing goods or services to the debtor, and the trustees never sought authority to pay the claims. *Id.* at 1008.

A

The Six Months Rule was recognized but not given precision of definition in one sentence in Section 77(b) of the Bankruptcy Act, 11 U.S.C. § 205(b) (1976):

> For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.[15]

The Six Months Rule emerged out of the practice of initiating railroad receiverships with an order appointing a receiver and authorizing or directing him to pay from operating receipts certain expenses incurred in the period immediately preceding the receivership. Thus the 1867 receivership order in *Gurney* v. *Atlantic & Great Western Ry.*, 58 N.Y. 358 (1874), directed the receiver to pay and discharge out

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[15] When first enacted in 1933, 47 Stat. 1474, the provision appeared in Section 77(c), and the first part read:

> For all purposes of this section claims against a railroad corporation which would have been entitled to priority over existing mortgages if a receiver . . .

The language of the 1978 Act, 11 U.S.C. § 1171(b), is the same in substance as that of Section 77(b).

of the balance of receipts, after paying the expenses of maintaining and operating the road, arrearages owing to laborers and employees for work in connection with the railway and such sums as were actually due for material and supplies furnished for the use of the company's railways. No general principle, analogous to that in admiralty, was thought to give priority to the last creditors who furnished necessary repairs and supplies to a railroad. *Galveston, H.&H. R.R.* v. *Cowdrey*, 78 U.S. (11 Wall.) 459, 480-82 (1871). As the court said in *Duncan* v. *Mobile & O.R.R.*, 8 F.Cas. 17, 19 (C.C. S.D. Ala. 1876) (No. 4,137):

> The fact that the floating debt was contracted in good faith for the benefit of the railroad company's property, and therefore for the benefit of the bondholders, is true of perhaps all such debts. But that does not give the floating debt creditors any ground upon which to claim that their debt should be paid first.

Nevertheless, receivership orders continued to authorize payment of wage and supply claims that accrued over various periods, ranging up to eight months before receivership. *E.g. Skiddy* v. *Atlantic M. & O.R.R.*, 22 F. Cas. 274, 279-80 (C.C.E.D. Va. 1879) (No. 12,922) (reciting terms of 1876 receivership order); *Taylor* v. *Philadelphia & Reading Co.*, 7 F. 377 (C.C.E.D. Pa. 1880) (reviewing terms of several pre-*Fosdick* receivership orders). On the eve of *Fosdick* v. *Schall*, 99 U.S. 235 (1879), the practice of allowing payment for operating expenses of the pre-receivership period was stated in broad terms in *Turner* v. *Indianapolis, B. & W. Ry.*, 24 F. Cas. 366 (C.C.D. Ind., S.D. Ill. 1878) (No. 14,258); the court observed that generally railroads were dilapidated when receivership started, the first receipts were used to rehabilitate the road, and the pre-receivership claims for labor and supplies were paid by later order; the court emphasized that a railway is a matter of public concern and that public as well as private interests require its continued operation. The court said that its experience

> . . . has satisfied it that practically, it would be well nigh impossible, looking at things as they actually exist, to operate the roads by receivers without some allowance for claims of the character mentioned, existing at the time of their appointment, and that the limitation already stated [*i.e.*, to six months, by analogy to the Illinois lien statute] is not an unreasonable one, in view of all the circumstances.

24 F.Cas. at 367. But the court in *Turner* thought it desirable that the bar obtain from the Supreme Court a decision enunciating some just principle that might be a guide in such cases. *Fosdick* v. *Schall*, one of three cases argued and decided together,[16] is said to have been decided "after a general invitation had been extended to the members of the bar of [the supreme] court interested in like cases, to present briefs on the questions arising in that case." *See Atkins* v. *Petersburg R.R.*, 2 F.Cas. 90, 92 (C.C.E.D. Va. 1879) (No. 604).

Fosdick v. *Schall* rejected a conditional vendor's claim for "rent" of gondola cars for the six months preceding and several months following receivership for a number of very sufficient reasons. But the Court sought to establish a basis in principle for the payment of certain pre-receivership claims. The Court commenced by saying that a court, asked by a mortgagee to appoint a receiver in a mortgage foreclosure suit

> . . . in the exercise of a sound judicial discretion, may, as a condition of issuing the necessary order, impose such terms in reference to the payment from the income during the receivership of outstanding debts for labor, supplies, equipment, or permanent improvement of the mortgaged property as may, under the circumstances of the particular case, appear to be reasonable.

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[16] The two cases argued with *Fosdick* v. *Schall* did not deal with the Six Months Rule, but followed *Fosdick* v. *Schall* in holding that the lien of the railroad mortgage did not extend to cars, *Fosdick* v. *Car Company*, 99 U.S. 256 (1879), or locomotives, *Huidekoper* v. *Locomotive Works*, 99 U.S. 258 (1879), purchased under contracts of conditional sale.

99 U.S. at 251-52.[17] Noting that a railroad foreclosure case is rarely completed without concessions by the parties from their strict legal rights, that much of railroad business is done on credit, and that often debts for "labor, supplies, equipment and improvements" are deferred so that bond interest may be paid and disastrous foreclosure postponed, the Court continued:

> In this way the daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses, are kept from those to whom in equity they belong, and used to pay the mortgage debt. The income out of which the mortgagee is to be paid is the net income obtained by deducting from the gross earnings what is required for necessary operating and managing expenses, proper equipment, and useful improvements. Every railroad mortgagee in accepting his security impliedly agrees that the current debts made in the ordinary course of business shall be paid from current receipts before he has any claim upon the income. If for the convenience of the moment something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition of such an order that what is due from the earnings to the current debt shall be paid by the court from the future current receipts before anything derived from that source goes to the mortgagees.

Id. at 252-53. Saying that if the mortgagee sought the extraordinary equitable relief of receivership, it had to do equity in order to get equity, the Court continued:

[17] The 1875 receivership order in the *Fosdick* foreclosure directed the receiver to pay all debts due for labor and services rendered within the preceding three months and all debts for "engines, iron, wood, supplies, cars, or other property purchased within said period of three months for the use of the company."

We think, also, that if no such order is made when the receiver is appointed, and it appears in the progress of the cause that bonded interest has been paid, additional equipment provided, or lasting and valuable improvements made out of earnings which ought in equity to have been employed to keep down debts for labor, supplies, and the like, it is within the power of the court to use the income of the receivership to discharge obligations which, but for the diversion of funds, would have been paid in the ordinary course of business. This, not because the creditors to whom such debts are due have in law a lien upon the mortgaged property or the income, but because, in a sense, the officers of the company are trustees of the earnings for the benefit of the different classes of creditors and the stockholders; and if they give to one class of creditors that which properly belongs to another, the court may, upon an adjustment of the accounts, so use the income which comes into its own hands as, if practicable, to restore the parties to their original equitable rights. While, ordinarily, this power is confined to the appropriation of the income of the receivership and the proceeds of moneyed assets that have been taken from the company, cases may arise where equity will require the use of the proceeds of the sale of the mortgaged property in the same way. Thus it often happens that, in the course of the administration of the cause, the court is called upon to take income which would otherwise be applied to the payment of old debts for current expenses, and use it to make permanent improvements on the fixed property, or to buy additional equipment. In this way the value of the mortgaged property is not unfrequently materially increased . . . . Under such circumstances, it is easy to see that there may sometimes be a propriety in paying back to the income from the proceeds of the sale

> what is thus again diverted from the current debt fund in order to increase the value of the property sold. The same may sometimes be true in respect to expenditures before the receivership. No fixed and inflexible rule can be laid down for the government of the courts in all cases.

Id. at 253-54. The Court emphasized that the power to compensate for diversions from the "current debt fund" rests on the fact that mortgage creditors have "got possession" of what in equity belongs to all or some of the general creditors:

> It follows that if there has been in reality no diversion, there can be no restoration; and that the amount of restoration should be made to depend upon the amount of the diversion.

Fosdick's principle, then, is one of mortgage law: that the mortgagee's interest attaches to *net* income, which arises only after the payment from gross earnings for all necessary operating and managing expenses, proper equipment, and useful improvements, and that, in consequence, to the extent that before or during receivership bonded interest has been paid, additional equipment provided, or lasting and valuable improvements in the mortgaged property have been made out of earnings which ought in equity to have been used to pay debts for labor, supplies and the like, the receivership court can use receivership income or, in some cases, the proceeds of sale of the mortgaged property, to pay the debts that, but for the diversion of funds, would have been paid in the ordinary course of business. *Hale* v. *Frost*, 99 U.S. 389 (1879), was decided later in the same term on the authority of *Fosdick* but without discussion; it approved the payment from net income earned during the receivership of pre-receivership claims for repair parts to equipment and for supplies furnished to the railroad's machinery department. The report is silent concerning any "diversion" of earnings to the advantage of the mortgagee before or during the receivership.

Atkins v. *Petersburg R.R.*, *supra*, professed reliance on

Fosdick, but approved the re-payment from income of the receivership of an advance made before receivership to pay arrears of wages in order to avert a strike. There was no reference to "diversion." The court said that:

> . . . it would be difficult to draw a distinction between the principles under which a court authorizes a receiver to make necessary expenses for operating a railroad and keeping it in a safe condition, and the principles embodied in the language quoted from the opinion of the supreme court, relating to sundry expenses of the railroad companies incurred before the appointment of receivers . . . . It is enough for us that no court has ever refused to issue [receiver's] certificates when it was necessary for repairing the road or keeping it agoing as a safe road; and if it may authorize such expenditures by a receiver, it may pay them if they have been made by the company before the appointment of a receiver.

2 F. Cas. at 94. And in *Taylor* v. *Philadelphia & Reading R.R.*, *supra*, the court similarly cited *Fosdick* as justifying a broad order permitting payment from income of claims for "labor, materials, etc., furnished for the operation of the road within five months" preceding receivership, 7 F. at 377-78, and as authorizing the issuance of receiver's certificates for the amounts involved so that the receivers could defer payment in case they found it necessary to apply earnings to protect valuable investments of the railroad.

Miltenberger v. *Logansport, C. & S.W. Ry.*, 106 U.S. 286 (1882), did not cite *Fosdick*. The critical issues in the case related to the circuit court's action in authorizing substantial capital expenditures to be incurred, in giving them priority over the *first* mortgage in a suit brought to foreclose the *second* mortgage on the road, and in effecting payment for the capital expenditures through first lien receiver's certificates authorized and sold before the first mortgagees sought to foreclose. The Court cited only *Wallace* v. *Loomis*, 97 U.S.

146 (1878), the cornerstone case on receiver's certificates, and *Barton* v. *Barbour*, 104 U.S. 126, 136 (1881), which cited *Wallace* v. *Loomis* for the general proposition that a court of equity may and in most cases ought to authorize the receiver to keep the road in repair and to manage and use it in the ordinary way until it can be sold to the best advantage of all interested. *Miltenberger* approved the circuit court's order directing immediate payment of interline claims for materials, repairs, and ticket and freight balances, some of which had accrued more than ninety days preceding the receivership, and charging the payments upon the earnings of the road "as with a first lien prior to all incumbrances upon" the railroad. The Court pointed out that the receiver's petition for the order stated that "payment of that class of claims was indispensable to the business of the road, and that, unless the receiver was authorized to provide for them at once, the business of the road would suffer great detriment." 106 U.S. at 311.[18] The Court said:

> Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay pre-existing debts of certain classes out of the earnings of the receivership, or even the *corpus* of the property, under the order of the court, with a priority of lien. Yet the discretion to do so should be exercised with

[18] The master who passed on the claims "disallowed several items in the receiver's accounts, claimed under the above heads, where the claims were made on the ground that the creditors threatened not to furnish any more supplies on credit unless they were paid the arrears." 106 U.S. at 311. The next sentence appears to refer to the master's action in disallowing the claims rather than to the receiver's action in paying them. "His action, sanctioned by the court, in allowing items within the scope of the orders of the court appears to have been careful, discriminating and judicious, so far as the facts can be arrived at from the record. It cannot be affirmed that no items which accrued before the appointment of a receiver can be allowed in any case." *Ibid.*

> very great care. The payment of such debts stands, *prima facie*, on a different basis from the payment of claims arising under the receivership, while it may be brought within the principle of the latter by special circumstances. It is easy to see that the payment of unpaid debts for operating expenses, accrued within 90 days, due by a railroad company suddenly deprived of the control of its property, due to operatives in its employ, whose cessation from work simultaneously is to be deprecated, in the interests both of the property and of the public, and the payment of limited amounts due to other and connecting lines of road for materials and repairs, and for unpaid ticket and freight balances, the outcome of indispensable business relations, where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment, the general consequence involving largely, also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and entitle them to be made a first lien.

106 U.S. at 311-12. *Miltenberger* is concerned, not with the "diversion" precept of *Fosdick*, but with the more general authority of the receivership court to accord priority status to pre-receivership claims in order to prevent the stoppage of a business impressed with the public interest. The case emphasizes the power of the court to effect payment of pre-receivership claims and the validity of the means it chooses to effect payment; the analysis is not in terms of the property interest of operating expense creditors in operating revenues and the limitation of the mortgagee's rights to net income, but it is in terms of paying those pre-receivership expenses that are brought within the principle of administrative expenses by their relation to the continuance of the railroad business.

The cases in the Supreme Court involving payment of pre-receivership operating expense claims which were decided in the twenty-odd years between *Miltenberger* and *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905), preserved the "diversion" principle expressed in *Fosdick* without losing sight of the separate *Miltenberger* approach. *Union Trust* v. *Souther*, 107 U.S. 591 (1883), allowed a pre-receivership supply claim on *Fosdick* "diversion" grounds; but the Court noted also that the receivership court's "right to impose terms does not depend alone on whether current earnings have been used to pay the mortgage debt, principal or interest instead of current expenses" (107 U.S. at 594), citing *Miltenberger*, and it indicated that the bondholders' election, in their own interest, to leave the loss-making company in possession to operate the road after there had been a default entitling the mortgage bondholders to take possession justified the court's use of receivership income to pay the expenses of pre-receivership operation.[19] *Burnham* v. *Bowen*, 111 U.S. 776 (1884), approved the payment of claims for coal furnished for the railroad's locomotives in the months preceding receivership. The Court emphasized that the bondholders permitted the company to possess and manage the road after default and observed that the "maintenance of the road and the prosecution of its business were essential to the preservation of the security of the bondholders." 111 U.S. at 780. In *Burnham* the order appointing the receiver did not provide for the payment of pre-receivership operating expenses; however, the Court held that the use of receivership income to pay fixed charges on certain railroad structures, increasing the bondholders' security

[19] *Union Trust Co.* v. *Walker*, 107 U.S. 596 (1883), decided with *Souther*, held that a purchaser of claims of "six months" creditors could enforce the claims, not because the creditors had a lien on the property and income but "because in equity the earnings of the company constitute a fund for the payment of the expenses which their claims represent, before any income arises which ought to be applied to the discharge of the mortgage debt." 107 U.S. at 596.

at the expense of the labor and supply creditors, was a "diversion" within *Fosdick*. "So far as current-expense creditors are concerned, the court should use the income of the receivership in the way the company would have been bound in equity and good conscience to use it if no change in the possession had been made." 111 U.S. at 782. The Court in *Union Trust Co.* v. *Illinois Midland Ry.*, 117 U.S. 434 (1886), was primarily concerned, as in *Miltenberger*, with the validity and priority of receiver's certificates, but it affirmed the grant of priority in the corpus of the property over the bonds for wages due for the six months preceding receivership. 117 U.S. at 464-65. To an objection that the order appointing the receiver provided only for payment of current operating expenses from current income the Court answered that "the terms of these orders do not impair or exclude the ample authority which the court would otherwise have, and otherwise has, to order the claims in question to be paid out of the property itself, with priority." *Id.* at 465. *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, 170 U.S. 355 (1898), affirmed a decree directing that a debt for locomotive coal delivered in the months preceding receivership be paid out of the current earnings in the hands of the receiver; the Court relied on language from *Burnham* v. *Bowen, supra,* and *Miltenberger,* as expressing an "equitable doctrine" the "dominant feature" of which was that a "superior equity" as against the mortgage bondholders, in income earned before and after the receiver's appointment, arises in favor of materialmen who furnish supplies essentially necessary to the continued operation of the railroad in the expectation of payment from current earnings. 170 U.S. at 367-68. The Court emphasized that, independently of the existence of any pre-receivership "diversion" of income, the equity of the coal company for payment out of income survived into the receivership, attached to the property in the receiver's possession, and, if a surplus of income arose in the receivership, entitled the coal company to demand that the

surplus be applied to payment of its claim. *Id.* at 369. The existence of that surplus the court found implicit in the fact that during receivership the road's receivers "expended for betterments on its railroad lines from the income of the roads during the receivership a sum much larger than the entire claim" of the coal company. *Id.* at 367-70. *Southern Ry.* v. *Carnegie Steel Co.*, 176 U.S. 257 (1900), affirmed a decree according priority payment for rail furnished during a period in excess of six months preceding receivership; the Court inferred that the rail was furnished for ordinary safe maintenance of existing lines;[20] the Court found that current receipts that should have been applied to payment of the steel company's claim had been applied during the receivership for the benefit of the bondholders by paying interest, sinking fund, and car trust debts and for construction and equipment.

Circuit court decisions, influenced by *Miltenberger*, clearly went beyond the *Fosdick* principle. *E.g.*, *Dow* v. *Memphis & L. R.R.*, 20 F. 260, 267 (C.C.E.D. Ark. 1884); *Blair* v. *St. Louis, H. & K. R.R.*, 22 F. 471, 472-73 (C.C.E.D. Mo. 1884). One case, in the Fourth Circuit Court of Appeals, in which Chief Justice Fuller wrote for the court, allowed the payment from the proceeds of the foreclosure sale of the road of interline claims for freight and freight balances that accrued before the appointment of the receiver. *Finance Co.* v. *Charleston, C. & C. R.R.*, 62 F. 205 (4th Cir. 1894). There were no surplus earnings before or during the receivership, nor had there been any diversion of income. The court relied on the broad terms of the order appointing

[20] A claim for extraordinary quantities of rails furnished before the receivership but outside the ordinary course of business, and for construction rather than repair, was not accorded priority. *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.*, 176 U.S. 298, 315-16 (1900); *Hale* v. *Frost, supra*, disapproved priority payment for pre-receivership supplies furnished to the road's construction department while approving such payment for repair parts and for supplies so furnished to the road's machinery department.

the receiver, saying that it could not be construed as limited to payment out of current earnings, "especially in view of the condition of the road." 62 F. at 208. Emphasizing that the payment of such debts was related to the interest in preserving and disposing of the property as a going concern, and to the interest in the road's discharging its public duty, the court said that

> . . . such indebtedness may be given priority, notwithstanding there may have been no diversion of income, or that the order for payment was not made at the time, and as a condition, of the receiver's appointment, the necessity and propriety of making it depending upon the facts and circumstances of the particular case, and the character of the claims.

62 F. at 208.

The Supreme Court did not sweep so broadly. *St. Louis, A. & T. H. R.R.* v. *Cleveland, C.C. & I. Ry.*, 125 U.S. 658 (1888), acknowledged the authority of *Fosdick*, but it refused to accord priority over the mortgage to a claim for the rental of a leased line. The Court said that the lessor would have to show that the rent arrearage had arisen "by the diversion and misappropriation of the fund that ought to have been applied to its payment to the use and benefit of the mortgage bondholders." 125 U.S. at 674. To the extent that the Court impliedly required a showing of diversion before the receivership, it appears to be repudiated in *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co., supra*, 170 U.S. at 365, 369. *Kneeland* v. *American Loan & Trust Co.*, 136 U.S. 89 (1890), was a case in which there were no surplus earnings before or during the receivership, no receipts were diverted to pay mortgage interest or to improve the road, and the foreclosure sale realized only a fraction of the mortgage debt; the Court held that an unpaid conditional vendor of rolling stock, whose cars were ordered returned to him before the foreclosure sale, would not be granted a priority claim for the reasonable

rental value of the cars used during the four months of their use by a receiver appointed upon a *judgment creditor's bill*, but that such a priority would be accorded to the claims for reasonable rent for use of the cars by a successor receiver appointed at the end of the four months upon the *mortgage trustee's foreclosure bill*. The Court was critical of "an idea" which "seems to have obtained that a court appointing a receiver acquires power to give such preference [that is, preference over mortgage debts] to any general and unsecured claims." 136 U.S. at 97. But in the same year the Court in *Morgan's L. & T. R.R. & S.S. Co.* v. *Texas Central Ry.*, 137 U.S. 171, 197 (1890), although denying priority to the claim before it, broadly restated both the *Fosdick* principle and that of *Miltenberger*. And *Kneeland* v. *Bass Foundry & Machine Works*, 140 U.S. 592 (1891), distinguished *Kneeland* v. *American Loan & Trust Co.*, *supra*, on its facts and as relating to a contract to buy rolling stock in which the vendor reserved title and reclaimed the rolling stock;[21] the Court in *Bass Foundry* affirmed an order for payment of claims for supplies furnished during the four month period for which the earlier *Kneeland* decision had rejected the reasonable rental value claim; the Court relied on *Fosdick* and *Miltenberger* and on *Union Trust Co.* v. *Souther*, *supra*. *Thomas* v. *Western Car Co.*, 149 U.S. 95 (1893), again rejected a car vendor's claim for a reasonable rental for the pre-receivership months and cited *Kneeland* v. *American Loan & Trust Co.*, but it put the decision in large part on the ground that the terms of the contract for the cars demonstrated that the vendor relied on the security of the cars themselves and not on the interposition of a court of equity.[22] 149 U.S. at 112. Similarly,

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[21] *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, *supra*, distinguished *Kneeland* v. *American Loan & Trust Co.*on essentially the same ground. 170 U.S. at 370-71.

[22] *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.* *supra*, treated *Thomas* as decided on the ground that the car company relied on the responsibility of the railroad company and not on the interposition of a court of equity. 170 U.S. at 371-72.

Penn v. *Calhoun*, 121 U.S. 251 (1887), and, later, *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.*, 176 U.S. 298 (1900), rejected priority claims where, in the first case, the creditor took as security bonds of the railroad for twice the amount of the claim, and, in the second, the creditor had taken collateral security for part of the debt and had extended and renewed long terms of credit; in neither case could it be found that the creditor relied on the railroad's current earnings for payment.

Gregg v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905), dealt with Gregg's claim for railroad ties delivered to the railroad in the month preceding the receivership; they were used principally during the receivership to maintain the railroad as a going concern, and the claim for payment was admittedly for a necessary operating expense incurred to keep and use the railroad and preserve the property in fit and safe condition. There had been no diversion of income by which the mortgagee had profited, or otherwise, and, the Court concluded, the circumstances affecting the claim were not "special." The Court said that the claim could not be charged on the *corpus* of the fund unless there was

> . . . a general rule that such claims for supplies are entitled to precedence over a lien expressly created by a mortgage recorded before the contracts for supplies were made.

197 U.S. at 186-87. The Court said that

> . . . we are of opinion, for reasons that need no further statement, *Kneeland* v. *American Loan & Trust Co.*, 136 U.S. 89, 97, that the general rule is the other way, and has been recognized as being the other way by this court.

197 U.S. at 187. Of the allowance of pre-receivership claims in *Miltenberger*, the supplier's principal reliance, the Court said:

> The ground of such allowance as was made was not merely that the supplies were necessary for the preservation of the road, but that the payment was necessary to the business of the road — a very different proposition.

Ibid. Other cases were distinguished as related to the special principle of *Miltenberger*, or as involving diversion of earnings, and cases like *Union Trust Co.* v. *Souther*, *supra*, where the receivership order authorized payment of six months claims for labor and supplies out of income, were explained as standing

> . . . on the special theory which has been developed with regard to income, and afford no authority for a charge on the body of the fund.

Id. at 188. The cases the Court cited as developing the "special theory" with regard to income are *Fosdick*, *Burnham* v. *Bowen*, *supra*, *Morgan's L. & T. R.R. & S.S. Co.* v. *Texas Central Ry.*, *supra*, *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, *supra*, and *Southern Ry.* v. *Carnegie Steel Co.*, *supra*. The Court added:

> It is agreed that the petitioner may have a claim against surplus earnings, if any, in the hands of the receiver, but that question is not before us here.

Ibid. The original receivership order in *Gregg* authorized the receiver to pay material and supply claims which accrued not more than six months before the receivership. Of this provision the Court said:

> But even if any words in the order authorized a charge on the corpus in order to pay claims like that of the petitioner, or a payment of them except from income, certainly there are none requiring it, or going beyond giving authority to the receiver if, for instance, he thought payments of previous debts necessary to the continued operation of the road.

Id. at 188-89.

Gregg is the last extended opinion on the Six Months Rule, and on the Necessity of Payment rule in the Supreme Court.[23]

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[23] *Baker* v. *Gold Seal Liquors, Inc.*, 417 U.S. 467, 471 n. 5 (1974), refers to the priority language of Section 77(b), to *Gregg* as to that priority, and to *St. Louis & S.F.R.R.* v. *Spiller*, 274 U.S.

The dissent clearly states the more inclusive principle that the Court's majority seemed to reject:

> And that principle has its foundation in the public interests. A railroad, from its nature and public responsibilities, must be kept a going concern. This is the supreme necessity, and affords the test of the equity invoked for the claims for supplies. It cannot depend upon diversion of income or upon the existence of income. It cannot be confined to debts contracted during the receivership. It may extend to debts contracted before the appointment of the receiver. But recognizing that there must be some limitation of time, the courts have fixed six months as the period within which preferential claims may accrue. And there is no infringement of the rights of mortgagees. Their interests are served, as those of the public are, by keeping the railroad in operation. The limitations of the rule dependent upon the conditions under which supplies are furnished are expressed in *Virginia & Alabama Coal Co.* v. *Central Railroad & Banking Co.*, 170 U.S. 355, and in *Southern Ry. Co.* v. *Carnegie Steel Co.*, 176 U.S. 257.

Id. at 196.

Carbon Fuel Co. v. *Chicago, C. & L.R.R.*, 202 F. 172 (7th Cir. 1912), a case in which there was neither surplus earnings nor any diversion of income, interpreted *Gregg* as limiting *Miltenberger* to the cases in which not the supply or service furnished to the railroad but *payment* by the receiver is essential to the continuance of the business of the railroad. *See*, to the same effect, *Taylor* v. *Delaware & E.R.R.*, 213

304, 311 (1927), as stating the general six months limitation on *Fosdick* claims. *New York Dock Co.* v. *S.S. Poznan*, 274 U.S. 117, 121 (1927), stated the *Fosdick* principle as requiring payment for supplies furnished before receivership where the debtor's or receiver's use of them "has produced the earnings;" the Court considered the result to flow from the courts' self-imposed duty to require that, before distribution, expenses that have contributed to the preservation or creation of the fund in its custody should be paid.

F. 622, 624 (2d Cir. 1914), *Moore* v. *Donahoo*, 217 F. 177, 180-83 (9th Cir. 1914), *cert. denied*, 235 U.S. (1915), *Chicago & A.R.R.* v. *United States & Mexican Trust Co.*, 225 F. 940, 945 (8th Cir. 1915), and *Crane Co.* v. *Fidelity Trust Co.*, 238 F. 693, 695-96 (9th Cir. 1916), *cert. denied*, 244 U.S. 658 (1917).

Pennsylvania Steel Co. v. *New York City Ry.*, 216 F. 458, 470 (2d Cir. 1914), however, referred to *Gregg* as the "most striking example of the uncertainty which surrounds the whole subject." The Court allowed pre-receivership supply claims against unmortgaged assets of the railway in the absence of any "current debt fund." The court said:

> If the preference is properly rested on public policy we do not see how it can be restricted to current earnings. Such claimants should be preferred over all general creditors, and if current earnings are not sufficient to secure the preference it should be extended to the company's unmortgaged assets.

216 F. at 471. *Johnson Fare Box Co.* v. *Doyle*, 250 F.2d 656, 657 (2d Cir.), *cert. denied*, 357 U.S. 938 (1958), paraphrased with apparent approval, a district court's assertion[24] that it is very difficult to discover any principle which would account for all the decisions, and that the only generality obtainable from the cases is that the decision in each depended on its special facts.

Southern Ry. v. *Flournoy*, 301 F.2d 847 (4th Cir. 1962), rejected the theory that *Gregg* severly limited *Miltenberger*, 301 F.2d at 852, and emphasized that, from *Miltenberger* forward, "public concern with the continued operation of the railroad has been a factor supporting the priority accorded

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[24] *In re Third Avenue Transit Corp.*, 138 F. Supp. 623 (S.D. N.Y. 1955), *aff'd on opinion below*, 230 F.2d 425 (2d Cir. 1956). *Third Avenue Transit* treated pre-receivership operating expense claims as enjoying priority only in net income of the railroad and of the receiver.

general creditors." *Id.* at 853.[25] The court accorded interline traffic balances and other interline accounts a priority in corpus over the mortgage bondholders. The court treated the time limitation, generally six months, as preventing operating claims from undermining the mortgage through secret liens. *Ibid.*

In re New York, N.H. & H. R.R., 278 F. Supp. 592 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969) ("*New Haven*"), saw the Six Months Rule as one that over the years had been inconsistently stated and applied in decisions that lacked any harmonizing principle, so that "ambiguities must generally be resolved against those claiming the benefit of the rule." 278 F. Supp. at 595-96. The rule of *Fosdick* was summarized:

> Revenues accruing from operations should be paid first to the operations creditors whose materials and services made those revenues possible; and only after all such operational claims have been paid, should the balance be available for the benefit of the mortgagees. If any operating revenues do improperly get into the hands of the mortgagees, equity requires that those revenues be restored to the operations creditors by the mortgagees yielding them a priority. (Footnote omitted.)

278 F. Supp. at 597-98. The "surplus earnings" element of the "current debt" or "expense" fund of *Fosdick* the court defined as the sum of all operating revenues accrued during the six months period and during reorganization and which have actually been received or taken over by the trustee less depreciation and all operating expenses that have actually

[25] The court noted its earlier statement in *Virginia Passenger & Power Co.* v. *Lane Bros.*, 174 F. 513, 516 (4th Cir. 1909), that in certain cases preferential payments have been allowed out of corpus. "One of the foundations of the principle is that the public interest requires that a railroad must be kept a 'going concern.' It does not depend, therefore, upon the diversion, or even upon the existence of income."

been paid, or are payable by the trustee, or which constitute administrative expenses.[26] *Id.* at 599. In *New Haven* the court found neither "surplus earnings," as it defined them, nor "income availab' for fixed charges," nor unmortgaged assets, nor any diversion to the mortgagees' advantage of current revenues to which the operations creditors were entitled, since neither the depreciation allowances nor payments on equipment trust and conditional sales obligations could be considered such diversions. *Id.* at 600-05. The court concluded that the six months creditors could not be accorded a priority in corpus over the mortgage bondholders. The court considered that *Flournoy* had confused and merged the Six Months Rule and the Necessity of Payment rule, "first enunciated in *Miltenberger*," by making necessity of payment a requirement of the Six Months Rule and eliminating diversion as a requirement of corpus invasion," directly contrary to *Gregg*. *Id.* at 602 n. 15. The court, on the supposed authority of *Gregg*, reduced *Miltenberger* to the case in which immediate payment is necessary to avert a threat to continued operation of the road, and characterized as "absurd" reliance on the Necessity of Payment rule by creditors whose claims had gone unpaid during six years of operation in reorganization. *Id.* at 602-03 n. 15.[27]

In re Tennessee Central Ry., 316 F. Supp. 1103 (M.D. Tenn. 1970), *vacated on other grounds*, 463 F.2d 73 (6th Cir.), *cert. denied*, 409 U.S. 893 (1972), accorded a

[26] The court differentiated its treatment of the six months earnings ("gross operating income" taken over and collected by the trustee less expense items payable on the date the petition was filed which the trustee was required to pay) from the scheme referred to in *Guaranty Trust Co.* v. *Albia Coal Co.*, 36 F.2d 34, 36 (8th Cir. 1929), that is, "gross operating income taken over or collected by the receiver less taxes accrued." 278 F. Supp. at 599.

[27] The Court of Appeals affirmed, 405 F.2d 50 (2d Cir. 1968), saying that the "current expense fund" for six months claims "is to be computed by deducting operating expenses and depreciation from current revenues." 405 F.2d at 52.

priority over mortgage bonds to claims for interline freight balances; the court found that the extensions of credit that the balances reflected averted a complete shutdown of the railroad's operation and facilitated the sale of the railroad to three other carriers which continued to operate it. The court relied in part on the special character of interline freight balances as collections for which the road had to account to connecting carriers, 316 F. Supp. at 1110, and ultimately on the circumstance that the connecting carriers' extension of credit preserved the corpus of the mortgaged railroad by maintaining it as a "going concern" and enabled the area formerly served by the railroad to enjoy continued rail services. *Id.* at 1111. The court argued that *Gregg* seemed to indicate that, where special circumstances or equities favored six months claimants, their claims might be allowed a priority in assets even in the absence of a diversion of income to the secured creditors' benefit. *Ibid.*

In re Penn Central Transp. Co., 458 F. Supp. 1234, 1319-28 (E.D. Pa. 1978), relied principally on *New Haven* as a distillation of a large number of earlier cases; the "current debt fund," the court said, included surplus income of the six months preceding reorganization as well as for the reorganization period, inclusive of non-rail income customarily made available to support rail operations; generally accepted railroad accounting principles were held applicable, depreciation being deducted from operating revenues in computing the "current expense fund." The deficit in Penn Central's income for the six months period and during reorganization exceeded the depreciation for the same period by very much more than the aggregate of the six months claims; since there was no earnings component for the *Fosdick* "current debt fund," and capital improvements for the same period (nearly four times the amount of the six months claims) were far less than the depreciation for the period, the court concluded that there

was neither enhancement of property nor "diversion."[28] 458 F. Supp. at 1325. The court rejected *Flournoy* as "discredited" and as impermissibly combining the six months and necessity rules, and treated the Necessity of Payment rule as stating the circumstance in which a court could justify entry of an order authorizing payment of a pre-reorganization creditor who invoked the sanction of refusal to furnish further supplies or services as a means of obtaining payment of his old claim.[29] *Id.* at 1326-27.

B.

The persistence of the Six Months Rule and the persistence of two distinct attitudes toward it, the one receptive and

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[28] The trustee evidently argued that $770 million spent on capital improvement should not be considered in the "diversion" calculation because the expenditure did not exceed the *increase* in depreciation reserve through charges to income in the period. The six months creditors apparently argued that this was "double dipping," taking depreciation into account twice, once to compute surplus earnings and a second time to absorb the capital expenditures' effect as a diversion to the advantage of the mortgage bondholders. The court sought to meet the argument with the statement that, if the amount of depreciation charged had actually been spent to make good the depreciation, that outlay "would not thereby have enhanced the mortgaged assets at the expense of the six months claimants." 458 F. Supp. at 1375. That, however, is, logically, a restatement of the conclusion that depreciation should be deducted in computing the earnings component of the *Fosdick* "current debt fund." The court met the argument directly by concluding that even adding back the depreciation did not produce *Fosdick* surplus earnings, leaving the capital expenditures in large part unexplained, however. *Ibid.*

[29] The court said that *In re Penn Central Transp. Co.*, 467 F.2d 100 (3d Cir. 1972), correctly stated the Necessity of Payment doctrine. The appellate court summarized the Necessity of Payment rule, an "exception to the normal deferment of payment of pre-reorganization claims until their disposition can be made part of a plan of reorganization," as permitting immediate payment where creditors will not supply services or material essential to the conduct of the business until their pre-reorganization claims are paid. 467 F.2d at 102 n.1. The appellate court intimated that a reorganization court might well have power to compel a continuance of a service sought to be withheld in order to coerce payment of an old claim. *Id.* at 102.

expansive, the other insistent upon its limitations and narrow sphere of operation, suggest the co-existence of two essentially different principles, neither of which limits the operation of the other, and both of which may operate in the same reorganization to embrace many of the same claims. The *Fosdick* rule is one of equitable restitution; in receivership the mortgagee must restore to operating creditors revenues diverted to the mortgagee's advantage; the lien of the mortgage extends to railroad revenue or income only when possession of the road and its income is demanded, pursuant to the mortgage terms after default, *Fosdick, supra,* 99 U.S. at 253; *Gilman* v. *Illinois and Mississippi Telegraph Co.*, 91 U.S. 603, 617 (1876); *Galveston, H. & H. R.R.* v. *Cowdrey, supra,* 78 U.S. (11 Wall.) at 482-83, and the lien reaches only what remains of revenue after payment of all current operating expenses. *Burnham* v. *Bowen, supra,* 111 U.S. at 782-83. The receivership furnishes the occasion and judicial means of effecting the equitable restitution, but mortgage law, not the special principles governing the administration of railroad receiverships, is the source of the right to restitution.

The second rule, elaborated and applied in *Miltenberger*, is peculiarly a principle of railroad receivership law, reflecting the view that a "railroad is authorized to be constructed more for the public good to be subserved, than for private gain . . . . It is . . . a matter of public right by which the courts, when they take possession of the property, authorize the receiver . . . in whose charge it is placed to carry on in the usual way those active operations for which it was designed and constructed, so that the public may not receive detriment by the non-user of the franchises." *Barton* v. *Barbour,* 104 U.S. 126, 135 (1881). *Miltenberger,* relied on *Wallace* v. *Loomis, supra,* 97 U.S. at 162-63, for the authority to issue receiver's certificates superior to the first mortgage lien to finance the payment of pre-receivership operating expenses, administrative expenses of the receiver and costs of new

construction, and relied on *Barton* v. *Barbour* for the public interest justification for continued operation of the railroad as a going business. 106 U.S. at 309-12. The Court said that payment of pre-receivership debts

> . . . where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment, the general consequence involving largely, also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and entitle them to be made a first lien.

Id. at 312. The Court's rationale excludes the inference that only those creditors are entitled to priority of payment who demand immediate payment as a condition of continuing to supply a service or commodity of which they are monopolists.[30] The Court was defining the *classes* of claims payment of which was indispensable to the business of the road and which, "unless the receiver was authorized to provide for them at once, the business of the road would suffer great detriment." *Id.* at 311. The Court's depiction of the disastrous consequences of failing to pay labor claims — a work stoppage[31] — or interline claims — a stoppage of traffic interchange — is directed to restricting the class of claims entitled to priority of payment to claims for those goods and services that are

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[30] As noted above, footnote 18, the special master disallowed "several items" where the claimants threatened "not to furnish any more supplies on credit unless they were paid the arrears." 106 U.S. at 311.

[31] In *Skiddy* v. *Atlantic, M. & O. R.R.*, *supra*, 22 F.Cas. at 281-82, the court, acting on such a ground, directed the receiver to pay eight months back wages to those employees only who continued in employment; claims of the remaining employees and claims for materials supplied under contracts made on the eve of receivership were denied priority. The district judge who joined in the *Skiddy* opinion evidently regarded it as overruled in its latter aspect by *Fosdick*. *Atkins* v. *Petersburg R.R.*, *supra*, 2 F. Cas. at 92.

indispensable to the continued performance of the transportation service. The point is to single out the pre-receivership expenses the payment of which although it — *prima facie* — may stand on a different principle from that governing payment of administrative expenses, "may be brought within the principle of the latter by special circumstances." *Ibid.* The test is not whether the claimant has the naked power to exert economic duress, but whether the expenses have the characteristics of those that the receiver pays from revenue as expenses of administration or pays out of the proceeds of the sale of first lien receiver's certificates. *E.g., Boston & Maine Corp. Trustee's Competitive Bidding Exemption*, 347 I.C.C. 234, 235 (1971). (Sale of certificates "for meeting payroll and other expenses which, if not met, would preclude continued provision of essential railroad transportation services.") An early district court decision, authorizing the issuance of receiver's certificates, summed up the principle:

> It is enough for us that no court has ever refused to issue [receiver's] certificates when it was necessary for repairing the road or keeping it agoing as a safe road; and if it may authorize such expenditures by a receiver, it may pay them if they have been made by the company before the appointment of a receiver.

Atkins v. *Petersburg R.R., supra*, 2 F. Cas. at 94.

Some decisions have, very evidently, read *Gregg* as reducing *Miltenberger* to a Necessity of Payment holding in the starkest economic duress form,[32] but *Gregg* is, rather, circumspect in

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[32] With one exception, later cases in the Supreme Court that cited *Miltenberger* relied also on the equitable restitution principle of *Fosdick*. *Virginia & Alabama Coal Co.* v. *Central Railroad & Banking Co., supra*, 170 U.S. at 365-66; *Illinois Midland Ry., supra*, 117 U.S. at 456-58; *Union Trust Co.* v. *Souther, supra*, 107 U.S. at 594. The exception is *Kneeland* v. *Bass Foundry & Machine Works, supra*, 140 U.S. at 596-97, where the claim was ordered paid out of corpus because the supplies covered by the claim "had been necessary to the continued operation of the road, and had gone into the general property covered by the mortgage" and "contributed to the preservation of the property during the receivership." Neither a surplus of earnings nor a diversion was involved.

its treatment of *Miltenberger;* it preserves the ambiguity of the *Miltenberger* language without explaining or applying it, and declines to find that Gregg's facts presented special circumstances warranting priority. The Supreme Court has since cited *Miltenberger* for the principle that claims with equities superior to the mortgagee's "may be accorded priority in payment although they arose prior to the receivership." *Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940).

The criterion of priority to have intrinsic validity must be found in the nature of the claim and in the nature of the reorganization. If the claim is for a service or supply indispensable to the maintenance and operation of the railroad, and if the railroad continues to operate while in reorganization, the real difficulty is in finding a ground on which a court can fairly deny payment of a pre-reorganization expense claim indistinguishable from current administration expenses that are being paid and indistinguishable from kindred operating expenses that were incurred in the ordinary course of business by the railroad company in the months preceding reorganization and were paid by the railroad before reorganization or were paid thereafter by the trustees as liabilities arising out of the operation of the railroad. If a claim has the generally accepted characteristics of a six months claim, as stated in the district court's opinion, 468 F. Supp. at 1002, that is, (1) it represents a current operating expense necessarily incurred, (2) was incurred within six months before the reorganization petition was filed, and (3) the goods or services were delivered in the expectation that they would be paid for out of current operating revenues of the railroad, and not in reliance on the road's general credit,[33] it will inevitably be for an expense indistinguishable from and essentially contemporaneous with

[33] To the same effect are *In re Penn Central Transp. Co., supra,* 458 F. Supp. at 1321; *In re New York, N.H. & H. R.R., supra,* 278 F. Supp. at 596; *Guaranty Trust Co.* v. *Albia Coal Co., supra,* 36 F.2d at 35.

expenses paid by the railroad before reorganization, and will be indistinguishable from currently paid administration expenses. The singularity of the claim will not be either in the goods or services which it represents, nor in their contribution to the railroad's service to the public, nor in their contribution to the preservation of the fabric of the railroad, but only in the fact that it will, of course, not be paid. No principle marks current expenses paid in ordinary course on the eve of reorganization as preferences, but denial of an equivalent right to priority payment for expenses of the same kind likewise incurred on the eve of reorganization introduces an inequality of treatment that finds no justification either in the principles on which businesses are continued in operation during receivership, or in the mortgagee's lien interest. The desideratum is equality of treatment for the current operating expenses of a railroad enterprise the operations of which have continued without interruption of service, revenues and expenses. That equality is readily achieved by recognizing administration expenses as extending backward to the period preceding reorganization to the extent necessary to assure that there is continuity in the payment of indispensable operating expenses without reference to the date the petition is filed so long as the current expenses of the pre-reorganization period that are brought forward for payment conform to the strict standard established for administration expenses of the current operating class, and are not so dated as to forbid the conclusion that they are in fact current. The inequity in treatment arising out of the accidental circumstance of non-payment before the filing of the petition is eliminated.

The hostility to "six months" claims evident in *Gregg, supra*, 197 U.S. at 186-87 and *New Haven, supra*, 278 F. Supp. at 596,[34] is no doubt in some part a product of the

[34] In contrast is the support for a broad receivership principle approach successively evident in *Finance Co.* v. *Charleston C. & C. R.R., supra*, 62 F. at 208, the dissent in *Gregg, supra*,

uncertain limits of the class of claims: six months is not an inflexible time limit, and each case "must depend largely upon its special facts," *Southern Ry.* v. *Carnegie Steel Co.*, *supra*, 176 U.S. at 292; the "surplus earnings" and the quantum of "diversion" relevant under *Fosdick* are puzzling concepts, *id.* at 294-95; *In re Penn Central Transp. Co.*, *supra*, 278 F. Supp. at 598-601; reliance on the general credit of the railroad seems an illusory concept, *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.*, 176 U.S. 298, 316-17 (1900) (security taken upon renewal of notes given for rail); *Southern Ry.* v. *Carnegie Steel Co.*, *supra*, 176 U.S. at 292 (if first notes given for rail contemplated payment from current earnings, seller "lost no equity merely by renewing the notes"); *Penn* v. *Calhoun*, 121 U.S. 251, 252 (1887) (bank took bonds of railroad to secure repayment of loan). But the definition of the class has been left to the courts by the Congress,[35] and when

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197 U.S. at 196, and *Flournoy*, *supra*, 301 F.2d at 851-52. The paragraph by which Chief Justice Waite introduced the discussion of priorities in *Fosdick*, *supra*, 99 U.S. at 251-52, is more easily referred to the broad receivership principle later elaborated in *Miltenberger* than to the narrow principle of equitable restitution that the following paragraphs of the opinion outline.

[35] The Commission on the Bankruptcy Laws of the United States, Report, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), *reprinted in* King, Klee and Levin, Collier on Bankruptcy (15th Ed.), Appendix, Vol. 2, Part I, p. 270, recommended retaining the "so-called six-month priority rule according to creditors who supplied necessities to the debtor within six months prior to the filing of the petition the status of administrative expense claimants." The Commission's recommended bill, in the "Confirmation of Plan" section (9-503), included a requirement that the plan provide "for payment of all allowed claims for current operating expenses incurred by the debtor during the six months immediately preceding the filing of the petition." *Id.*, Part I, p. 288. The Senate in 1978 would have followed the Commission recommendation to provide that "traditionally accorded" priority (S. Rep. No. 95-989, 95th Cong., 2d Sess. 135-36, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5921-22), and S. 2266, 95th Cong., 1st Sess. § 1173(a) (9) (1978), required that the "Plan" include a provision for payment in cash of all allowed claims for current operating expenses during the six months preceding the filing of the petition. The House Bill, H.R. 8200,

the time comes to determine membership in the class[36] it will be for the reorganization court to determine what claims belong in the class because they represent indebtedness for ordinary and necessary current operating expenses indispensable to continued rail service of the kinds being paid currently as expenses of administration; whether the non-payment reflects an intentional extension of credit to the railroad, or the intervention of the reorganization petition before expiration of the ordinary billing and payment period, or some non-contractual indulgence or inadvertence on the part of the claimant, or deferment of payment on the part of the railroad; and whether, if the transaction giving rise to the claim had any credit term, it was compatible with a general expectation of payment from current receipts or indicated reliance on the railroad's general credit. In any event, it must be concluded that the class of creditors entitled to the priority contemplated by Section 77(b), 11 U.S.C. § 205(b) (1976), is not limited to participation in the current debt (expense) fund defined in terms of *Fosdick* equitable restitution, but extends to participation in reorganization railway operating revenues essentially on the same basis as administration expenses incurred during the reorganization period.

C.

Where payment for pre-reorganization services and supplies is claimed on the ground that the expenses are within

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95th Cong., 1st Sess. (1977), which in substance proposed to continue, as Section 1170(b), the language of former Section 77(b), and H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 424, *reprinted in* [1978] U.S. Code Cong. & Ad. News 6380, stated that "As under current law, the courts will determine the precise contours of the priority recognized by this subsection in each case." The provision enacted as 11 U.S.C. § 1171(b) follows the House Bill and substantially continues the language of Section 77(b).

[36] Since the district court disposed of the six months claims on the ground that there was no current debt fund, 468 F. Supp. at 1003, and no diversion, *id.* at 1004-06, and did not designate a priority classification for six months creditors, *id.* at 1008, the court did not refine its definition of the class, *id.* at 1002, nor set out the limitations on membership in such a class.

the principle governing the priority accorded to administration claims, questions respecting the existence of a current expense or debt fund, that is, of surplus earnings or net income, are not directly involved; the controlling considerations are those taken into account in authorizing administration expenses.

However, if payment is claimed under the *Fosdick* principle, the existence of a current debt fund must be demonstrated. The district court's analysis of the financial data, 468 F. Supp. at 1002-04, 1005-07, establishes that there were no surplus revenues but a deficit in operating income and income available for fixed charges in the period from September 13, 1969, to July 31, 1978, and that the operating deficit exceeded the amounts arguably expended to the mortgagee's advantage. However, in its analysis the district court defined the earnings (deficit) component of the current expense fund as comprising revenues less operating expenses *and depreciation*, *id.* at 1003; the court rejected the argument that providing an allowance for depreciation out of revenue enhanced the mortgaged assets and so was a diversion, *id.* at 1006-07; it indicated approval of the *New Haven* view that depreciation reflects the consumption of the railroad property through use, and that the depreciation allowance is comparable to expenditures made merely to preserve and not to increase the mortgaged assets. *Ibid. See New Haven*, *supra*, 278 F. Supp. at 604; *In re Penn Central Transportation Co.*, *supra*, 458 F. Supp. at 1324-25; note 28, *supra*.

Certainly the depreciation of income producing property, the exhaustion of its utility over the years of its useful life, is an objective fact.[37] It is, however, not related to ordinary

[37] When *Fosdick* was decided some railroads at least charged certain classes of additions and betterments to revenue, *see Union Pacific R.R.* v. *United States*, 99 U.S. 402, 420-22 (1879), and until the 1920s "retirement accounting" was common, that is, no annual depreciation charges were made against revenue, but when capital assets were retired their original cost was charged to revenue

repair and maintenance; it relates to the exhaustion of useful life despite regular repairs and maintenance. Depreciation is by its nature indelibly a capital charge, the cost, allocated to the accounting period, of the capital used to produce the revenue of that period. If the depreciation reserve is considered an accumulating fund, and not simply a record of the annual postings of fractions of the original capital cost, it is a fund accumulated to restore the original capital investment in money, or to provide a new capital asset. But the annual charges to revenue for depreciation of capital assets do not create a fund in specie that preserves the identity and stands in place of the depreciable asset and is subject to any mortgage that there may be on the asset. There is no suggestion that, here, the railroad did, or that, generally, railroads do undertake with their mortgage bondholders that they will use an amount equal to annual depreciation to make good — if that could be done — the physical depreciation of the mortgaged property. Something roughly like that may no doubt occur in good times as a portion of earnings each year is reinvested in the road, but such reinvestments are capital outlay for new assets themselves depreciable, and that the new investments may not exceed the depreciation charges of the same period means only that — assuming constant prices — the road is losing old capital values through use faster than it is acquiring new capital assets. In good times new capital assets acquired will often, perhaps usually, come under the after-acquired property clauses of the mortgage, and the long term mortgagee

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in the year of retirement. *See Depreciation Charges of Telephone Companies*, 118 I.C.C. 295, 302-03, 305-07 (1926) (outlining railroad practices and position); *Illinois Central R.R.* v. *I.C.C.*, 206 U.S. 441, 461-63 (1907); *cf. Kansas City Southern Ry.* v. *United States*, 231 U.S. 423, 445-48 (1913) (railroad arguing unsuccessfully that, where new roadbed and track replaced short section of old roadbed and track in order to improve grade and speed and reduce cost of service, the abandonment cost of the old track did not have to be charged to revenue).

will have a kind of slowly revolving security.[38] But first to last depreciation is related to capital, its exhaustion, and its replacement, not to its maintenance, and it is not an expenditure that affects cash flow of the accounting period.

The Boston and Maine accounts recorded an aggregate net railway operating loss in the period September 13, 1969, to December 31, 1977, of $42.5 million, and of that $33.2 million represented charges for depreciation. That amount could not represent a diversion of revenues to the mortgagee's advantage for the all-sufficient reason that it was not a current expenditure in any sense. If in the same period revenues were used for capital expenditures and to retire secured obligations (*supra* page 12), they were so used whether or not depreciation charges were made, and they had the special significance that *Fosdick* attaches to such expenditures, quite without reference to the amount of depreciation currently charged. *Fosdick* is concerned with the priority in operating revenues owed to current operating expenses. To rank depreciation charges equally with current operating expenditures in their claim upon revenue is to reject the priority that *Fosdick* recognized. The mortgage does not extend to the assets plus the depreciation reserve built up over the years against the assets, but only to the wasting asset itself. When in receivership the *Fosdick* principle intervenes, the priority of current operating expenses in revenue precludes any deferment to depreciation charges

[38] *Uniform System of Accounts for Railroad Companies*, 309 I.C.C. 289 (1959), approved the railroads' dispensing with retirement and depreciation accounting for track maintenance; observing that the useful life of the composite track structure is semipermanent in the sense that, when properly maintained, the end of its life span is unforeseeable, the I.C.C. concluded that no good purpose would be served by requiring retirement and depreciation accounting for track so long as the railroads continued to maintain existing track in proper condition through adequate replacement, as needed, of rails, ties, ballast and other material so that deterioration in track structure and impairment of the corporation's capital investment was avoided. 309 I.C.C. at 292, 296. Track maintenance illustrates the revolving security concept.

that, if allowed in the *Fosdick* calculation, would be a direct set-aside of revenue for the mortgage bondholders at the cost of the current-expense creditors. No ground exists for allowing depreciation in a *Fosdick* calculation of earnings that would not as a logical corollary require trustees' certificates to share their lien rank with the sum of the depreciation allowances recorded since March 12, 1970, for, in the ultimate sense, trustees' certificates, to the extent that they do not rest on "free assets," are a charge on the revenues from which expenses of administration, in considerable part current operating expenses, are paid.

D.

The district court rejected the appellants' contention that the Necessity of Payment rule is a rule of priority and accepted the conclusion of *New Haven*, *supra*, 278 F. Supp. at 603 n. 15, that the rule is not based on considerations of equity but is a device for handling a threat to the continued operation of the railroad *during reorganization*. 468 F. Supp. at 1008. To the extent that a strict necessity of *payment* rule has developed from the cases it would not be a rule conferring a right of recovery on the claimant but a rule of exculpation, protecting the trustee who paid under economic duress for a supply or service indispensable to continued operation of the railroad. *See In re Penn Central Transportation Co.*, *supra*, 458 F. Supp. at 1326 ("By definition, the necessity of payment rule is one to be invoked by Trustees, as justification for their decision to pay these unsecured pre-bankruptcy claims.") Under this distinct rule the district court was clearly right in its conclusion that, since no creditor claiming under that rule had insisted on payment of its claim as a condition of providing goods and services to the debtor, and since the trustees had never sought authority under the rule for payment of any such claims, the rule was inapplicable and the claims under it groundless.

E.

To summarize on this second aspect of the case, we hold:

1. The *Fosdick* principle, essentially one of equitable

restitution on principles of mortgage law, and the special principle of receivership administration that emerged in *Miltenberger* are co-existing but distinct principles.

2. The *Fosdick* principle of equitable restitution provides for payment of claims for pre-reorganization current operating expenses from and to the extent of the existence of a current debt fund determined essentially as indicated in *New Haven* and in *In re Penn Central Transportation Co., supra,* 458 F. Supp. at 1322-23, except that depreciation is not deductible in determining the amount of the income component of the current debt fund.

3. The *Miltenberger* receivership-administration principle provides for payment of claims on the same basis and from the same operating income as administration expenses for pre-reorganization current operating expenses that satisfy the strict requirements of the class, that is, that they are claims for necessary current operating expenses not furnished in reliance on the railroad's general credit.

4. The Necessity of Payment rule, as it has emerged as a distinct third principle, does not confer rights on claimants; it rather reflects the existence of a judicial power to authorize trustees in reorganization to pay claims where such payment is exacted as the price of providing goods or services indispensably necessary to continuing the rail service, and it reflects the existence of a corollary judicial power to exculpate trustees who may have made such payments in exigent circumstances without first obtaining authorization by court order.

III

It follows from what has been said that the order of the district court of March 19, 1979, must be reversed in so far as it failed to provide a separate class of creditors, with priority pursuant to Section 77(b) of the former Bankruptcy Act, 11 U.S.C. § 205(b) (1976), now 11 U.S.C. § 1171(b), and in all other respects affirmed.

Reversed in part, affirmed in all other respects, and remanded for further proceedings consistent with this decision.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

IN THE MATTER OF
BOSTON AND MAINE CORPORATION
DEBTOR

MEMORANDUM

MURRAY, *Senior District Judge*

The Debtor's Trustees have petitioned the court to fix the division of creditors and stockholders in the reorganization proceedings according to the nature of their respective claims and interests, pursuant to Section 77(c)(7) of the Bankruptcy Act (the Act), 11 U.S.C. § 205(c)(7). The Trustees suggested an order of priorities of creditors and stockholders divided into eleven categories, to which objections were filed. The petition and objections came on to be heard by the court, after notice to the Interstate Commerce Commission (ICC) and to all creditors and stockholders, on the several stipulations of the Trustees and certain creditors, the briefs filed by the Trustees and certain objectors, and the oral arguments on behalf of the Trustees and certain creditors.

I. *Per diem claims*

Thirty-eight railroads[1] and Trailer Train Company (collectively the "interline claimants") object to the classification by the Trustees of their pre-reorganization per diem charges against the Debtor in a category subordinate to the holders of general unsecured claims. The interline claimants seek to have the court establish them as a separate class of creditors with

[1] The railroads are: Baltimore And Ohio R. Co., Chesapeake And Ohio R. Co., Western Maryland Ry., Maine Central R. Co., Canadian Pacific R. Co., and the Committee of Interline Railroads which represents 34 railroads.

respect to these per diem charges at a high-level priority, or at the very least at priorities under the "six months rule" or "necessity of payment rule". Earlier in the reorganization proceedings against the Debtor the question whether these per diem charges were entitled to priority over the claims of other creditors was raised when the interline claimants sought an order requiring the Trustees to make immediate payment of such charges. This court declined to follow the decision *In The Matter of Chicago, R.I. & P.R. Co.*, 537 F.2d 906 (7th Cir. 1976), *cert. denied* 429 U.S. 1092 (1977) (*Rock Island*) on the priority issue, and denied the interline claimants' petitions. *In the Matter of Boston And Maine Corporation, Debtor*, 456 F. Supp. 412 (D. Mass. 1978). On the instant petition the interline claimants have again urged certain contentions which they raised in the earlier proceedings. Ordinarily, consideration of the same arguments would not be entertained. However, because the court is now called upon for the first time to undertake its statutory duty under section 77(c)(7) to fix the division of creditors and stockholders "for the purposes of the plan [of reorganization] and its acceptance", *id.*, it will not foreclose reconsideration of the arguments.

Interline claimants are not entitled to special priority

Pre-reorganization per diem charges are part of the operating expenses of the railroad, are unsecured debts within the meaning of the Bankruptcy Act [11 U.S.C. §§ 1(14), 205(b)], and entitled to no designated preferred priority among the debts of the railroad in reorganization. Neither the Bankruptcy Act nor the Interstate Commerce Act, 49 U.S.C. § 1 *et seq.*, specifically provides for priority status of per diem claims over claims of other creditors.[2] There is no explicit

[2] This is particularly significant in light of the specific priority given certain claims in section 77. *See* 11 U.S.C. § 205 (n) (claims of employees for personal injuries; claims of sureties on certain bonds); 11 U.S.C. § 205 (c) (3) (claims under trustees' certificates); 11 U.S.C. § 205 (b) (unsecured claims under the "six months rule"). *See In re Chicago Express, Inc.*, 222 F. Supp. 566, 571 (S.D. N.Y.

general order of the ICC directing the trustee of a railroad in reorganization to pay pre-reorganization per diem charges; there is no specific order of the ICC requiring the Trustees of this Debtor to pay such charges. There has been no demonstration that the interline carriers, some of them competitors of the Debtor, conferred on the Debtor such special benefits by the services for which the per diem charges were made as to equitably entitle them to a preference over all other creditors. The view of the Third Circuit that with respect to pre-reorganization per diem charges interline claimants are entitled to no higher priority than other unpaid suppliers of goods and services delivered prior to the filing of the petition in reorganization, *In re Penn Central Transportation Company*, 486 F.2d 519, 528 (3rd Cir. 1973), *cert. denied* 415 U.S. 890 (1974); *Matter of Penn Central Transportation Company*, 553 F.2d 12, 15 (3rd Cir. 1977), correctly appraises the interests of the interline claimants in relation to other creditors.

Relying on *Rock Island* the interline claimants contend, however, that because of the mandatory nature of certain ICC orders prescribing per diem rates and rules for the settlement of per diem accounts, the court must distinguish between the asserted singular nature of their per diem charges and claims of other creditors in any priority classification of creditors. As previously pointed out in this memorandum, this court declined to follow *Rock Island* on the priority issue, and there is nothing in the presentations made on the instant petition to persuade the court to change its views (1) that the rationale of *Rock Island* does not support a preferred priority status for per diem charges of approximately $8,018,000 for services performed before August 1, 1969, and (2) that to accord preferred priority to per diem charges of approximately $564,000 for pre-reorganization services rendered after August 1, 1969

1963), *aff'd* 332 F. 2d 276 (2d Cir. 1964), *cert. denied* 379 U.S. 879 (1964), where the court said: "Where Congress intended that special priorities be granted 'it has carefully enumerated them and any omissions must be construed as express exclusions . . .' ". (Citations omitted).

would result, in the absence of clear and specific statutory authority and policy, in insulating interline carriers as creditors from the strictures of section 77 contrary to the intent of Congress.[3]

Any consideration of the extensive powers of the reorganization court under section 77 to control and adjust the claims of creditors must take account of the traditional bankruptcy goals of that section: rehabilitation of the debtor and equitable distribution of the debtor's property to creditors. *See New Haven Inclusion Cases*, 399 U.S. 392, 420 (1970). By the terms of section 77(c)(7), the traditional bankruptcy function of establishing priorities among creditors is exclusively that of the reorganization court, and not a function of the ICC.[4] Thus, the contention that the court's power to determine the priority of distribution of the property of a debtor in reorganization to a class of interline creditors in relation to the claims of other creditors has been circumscribed by the superseding authority of ICC, carries a very heavy burden of persuasion. That

[3] It is undisputed that the Debtor's Trustees have paid all per diem charges at the ICC prescribed rates for car use furnished *after* the Trustees had assumed control over railroad operations. Such action complies with their duty under section 77(c)(2) to operate the business of the Debtor "subject to the control of the judge and the jurisdiction of the Commission". However, the language of section 77(c)(2) cannot be read to displace the power of the court to determine the rights and liabilities of creditors, including interline creditors, for services rendered *before* the Trustees assumed control over railroad's operations. Neither can section 77(c)(2) be read to mandate retrospective application to pre-reorganization operations of the Trustees' "power to operate the business of the debtor". *Id.*

[4] Section 77(c)(7) must be considered with other provisions of section 77, particularly section 77(e) which provides that the reorganization court

> . . . shall approve the plan if satisfied that: (1) It . . . is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders; . . . .

burden has not been met by the interline claimants; with respect, the court declines to follow the reasoning of the *Rock Island* court on the issue. Rather, the court concludes that proper consideration of the clear and specific applicable provisions of section 77, and its underlying policies, requires the ruling that the court is vested with the determination of the claims for special priority of pre-reorganization per diem charges and the classification of the interline claimants. Accordingly, for the reasons stated, the court determines that the interline claimants are not a special class of creditors entitled to special priority.

II. *Six Months Rule*

The interline claimants and certain other creditors[5] holding unsecured claims seek to have their claims approximating $3,000,000 accorded special priority under the so-called "six months rule". Debtor's Trustees contend that establishment of a separate class of creditors to be accorded priority as "six months creditors" is not justified under the circumstances of the case. In general, the parties are in agreement as to the origin of the rule and its elements; they do not entirely agree as to its intended application. They agree that it was made applicable to railroad reorganization proceedings by section 77(b), which provides in pertinent part:

> . . . unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.

The rule was first enunciated in *Fosdick* v. *Schall*, 99 U.S. 235 (1879). Since that time the rule has been applied in numerous cases, resulting in many inconsistencies among the decisions of courts below the Supreme Court. *Compare, e.g.*,

[5] The other creditors are Eastern Associated Coal Corporation, Exxon Corporation, Uniroyal Inc., and Francis J. Robertson.

In the Matter of Penn Central Transp. Co., 458 F. Supp. 1234 (E.D. Pa. 1978) ("*Penn Central*") and *In the Matter of New York, New Haven and Hartford R. Co.* 278 F. Supp. 592 (D. Conn. 1967) ("*New Haven*"), *aff'd*, 405 F.2d 50, (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969) with *Southern Ry.* v. *Flournoy*, 301 F.2d 847 (4th Cir. 1962). Because its application depends upon the facts peculiar to each case, *Southern Ry. Co.* v. *Carnegie Steel Co.*, 176 U.S. 257 (1900), the rationale of the rule is most important. In *Fosdick* the Court said:

> [W]hen companies become pecuniarily embarrassed, it frequently happens that debts for labor, supplies, equipment and improvements are permitted to accumulate, in order that bonded interest may be paid and a disastrous foreclosure postponed, if not altogether avoided. In this way the daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses, are kept from those to whom in equity they belong, and used to pay the mortgage debt. The income out of which the mortgagee is to be paid is the net income obtained by deducting from the gross earnings what is required for necessary operating and managing expenses, proper equipment and useful improvements. Every railroad mortgagee in accepting his security impliedly agrees that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income. If for the convenience of the moment something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition of such an order that what is due from the earnings to the current debt shall be paid by the court from the future current receipts

> before anything derived from that source goes to the mortgagees.

99 U.S. 252-53.

To qualify under the rule a creditor must establish (1) that the claim represents a current operating expense of the railroad necessarily incurred, (2) that it was incurred within six months prior to the filing of the reorganization petition, and (3) that the goods or services were delivered on credit with the expectation that the debt would be paid out of the current operating revenues of the railroad, and not in reliance on the railroad's general credit. *Penn Central, supra* at 1321. However, it must also be proved, before any right to priority under the rule can be established, that a "current debt fund" (also sometimes referred to as a "current expense fund") exists, or should equitably be re-created, out of which priority payments can be made. *Id.* The question whether such fund exists or should be re-created is the principal point of dispute between the Trustees and the creditors, and is the sole issue to be determined with reference to the six months rule on this petition.

Before addressing the issue of the "current debt fund", certain general principles concerning the applicability of the rule should be noted. The rights of qualified six months creditors are superior to the rights of the mortgagees in the current operating revenues of the railroad. *Fosdick* v. *Schall, supra* at 252-53. Six months creditors have no rights in the "corpus" of the debtor's estate except to the extent that current revenues have been improperly diverted for the benefit of the mortgagees. *Id.* at 254; *New Haven, supra* at 602; *Penn Central, supra* at 1321. The priority of qualified six months creditors is superior to the claims of pre-bankruptcy secured creditors, *New Haven, supra* at 597-98, but not to the claims of administration expenses incurred during the reorganization period. *Penn Central, supra* at 1321. The trustee of a railroad in reorganization is responsible only for funds coming into his

hands, and he cannot be required to recover payments made by the railroad before bankruptcy of non-operating current debts. *See Penn Central, supra* at 1321.

Current Debt Fund

The existence of the current debt fund is to be determined as of the date of distribution of the debtor's estate with the relevant period beginning six months before the reorganization petition was filed and including the reorganization period. *Penn Central, supra* at 1323; *accord, New Haven, supra* at 600. Hence, a classification determination made prior to distribution may be subject to later revision if circumstances change.

The six months rule does not operate to impress an equitable lien upon operating revenues, or upon net income, received during the six months period, or at some later point of time before the date of distribution, as earmarking the current debt fund. The rule stems from the familiar rule of courts of equity when administering a fund or property in the hands of its officer: receiver or trustee, and applies when making disposition of the earnings of property in the custody of the court. *See Fosdick, supra; see also In re Chicago Express, Inc.*, 332 F.2d 276, 278 (2d Cir. 1964). The Trustees argue that *New Haven* should be followed, with certain modifications, as to possible sources of the current debt fund. In *New Haven* Judge Anderson pointed out that

> such a fund may arise out of one or more of the following: (a) current earnings in the sense of surplus earnings during the six months period and during the reorganization itself; (b) unmortgaged assets of the debtor; and (c) income diverted during the six months period or during the reorganization for the benefit of the mortgagees.

278 F. Supp. at 598. The same formulation was adopted by Judge Fullam in *Penn Central*, with some doubt expressed by him as to the propriety of inclusion of unmortgaged assets. The interline claimants contend that this formulation is not in ac-

cord with *Fosdick* and other Supreme Court cases and, therefore, should not be followed.

1. *The revenue element*

The objecting creditors argue that contrary to *New Haven* and *Penn Central*, the source of the revenue element of the current debt fund is the railroad's "current receipts". In their memorandum of law the interline claimants say, at page 19: "The current debt fund, as identified and defined in *Fosdick* . . . and other Supreme Court cases, is a very simple concept: The fund is a company's current receipts". However, they do not identify in the evidence what they refer to as the "current receipts" of the Debtor here. They avoid explicitly identifying "current receipts" with the Debtor's "gross operating revenues". What they have done is to direct the court's attention to the gross operating revenues of the Debtor of $34,047,000 for the six months prior to March 12, 1970, and of $713,535,000 through July 13, 1978, and argue from these amounts that "[t]here were, thus, ample current receipts available during the six months period in a 'current debt fund' to pay six months operating creditors". Memorandum . . . of Interline Railroads, p. 22.

This oversimplification does not purport to demonstrate that any of the receipts realized during the six months period were "kept from those to whom in equity they belong, and used to pay the mortgage debt". *Fosdick*, *supra* at 253. The argument focuses merely on the phrase "current receipts" and ignores the rationale of the rule. It fails to consider whether any funds came into the hands of the Trustees when they were appointed, and fails to take into account what uses were made of the gross operating revenues during the six months period. The determination whether a current debt fund exists or should be recreated involves an inquiry into the debtor's operations much beyond the mere observation that indeed there were current receipts because there were gross operating revenues. The court rejects, as either unclear or a misconstruction of the

phrase "current receipts" the argument of the interline claimants that the current debt fund is merely the "current receipts". Rather, the court will adopt, with perhaps some reservation at this juncture, the definition in *New Haven* as follows:

> The current expense fund available from earnings can be defined . . . as the sum of all operating revenues which have accrued during the six months period and in the course of reorganization, and which have actually been received or taken over by the Trustees, less depreciation and all operating expenses which have actually been paid or are payable by the Trustees or which constitute administration expenses.

278 F. Supp. at 599.

In affirming *New Haven*, the Second Circuit Court of Appeals stated:

> We hold that the availability of a current expense fund under the six months rule is to be determined by generally accepted accounting practices, including those prescribed by the Interstate Commerce Commission and that under those practices the current expense fund is to be computed by deducting operating expenses and depreciation from operating revenues.

In re N.Y., N.H. & Hartford R.R. Co., 405 F.2d 50, 52 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969).

The evidence here clearly demonstrates that there is no basis for finding the existence of a current expense fund from the operating revenues. No surplus revenues accrued in the six months period and during the course of reorganization.[6] The current liabilities of the railroad of $30,929,401 exceeded the

[6] During the period September 13, 1969 through December 31, 1977, gross operating revenues of the Debtor totalled $696,552,000, and gross operating expenses, including a depreciation allowance of $33,212,000, totalled $739,055,000. These figures, and the figures used in the analysis of the evidence which follows are taken from the Debtor's schedules filed with the ICC.

current assets of $14,704,246 by approximately $16,000,000 when the Trustees assumed control on March 12, 1970. The railroad incurred a net loss from railway operations during the six months period of $3,588,000, and if non-operating net income realized during this period were added, there still was a net loss of $3,441,000. There has been no showing that there is presently a surplus of operating income in the hands of the Trustees. During the entire period from six months prior to the filing of the petition on March 12, 1970 until July 31, 1978 there was a net loss from railway operations of $40,720,000, and a deficit in income available for fixed charges of about $29,407,000. Whether any of the operating revenues were "kept from those to whom in equity they belong" remains to be considered.

2. *Diversion for benefit of mortgagees*

Where the Trustees do not possess surplus earnings in their hands to satisfy six months creditors' claims, the court may look to the corpus of the estate for any income diverted during the relevant period for the benefit of the mortgagees. *See Fosdick, supra* at 254. Supreme Court cases and other federal cases hold that an invasion of the corpus of the estate for this purpose is permissible only to the extent that the current debt fund has been diverted to the benefit of mortgagees. *See, e.g., Fosdick, supra* at 254:

> [If] it appears in the progress of the cause that bonded interest has been paid, additional equipment provided, or lasting and valuable improvements made *out of earnings which ought in equity to have been employed to keep down debts for labor, supplies and the like*, it is within the power of the court to use the income . . . to discharge obligations which, but for the diversion of funds, would have been paid in the ordinary course of business. . . .
>
> * * *

> Whatever is done [by the court] must be with a view to a restoration by the mortgage creditors of that which they have thus inequitably obtained. It follows that *if there has been in reality no diversion, there can be no restoration;* and that *the amount of restoration should be made to depend upon the amount of diversion.* (emphasis added)

See also St. Louis, A.&T.H. R.R. Co. v. Cleveland, C., C. & I. R. Co., 125 U.S. 658, 674 (1888); *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183, 187 (1905); *New Haven, supra* at 602; *Penn Central, supra* at 82.

There is some opinion to the contrary, *see, e.g., Southern Railway Co.* v. *Flournoy*, 301 F.2d 847 (4th Cir. 1962); *In re Tennessee Central Ry. Co.*, 316 F. Supp. 1103, 1111-12 (M.D. Tenn. 1970). However, the better view and the weight of authority clearly require the showing of a diversion of income for the benefit of the mortgagees before invasion of the corpus for the benefit of six months' creditors will be permitted. In *Johnson Fare Box Company* v. *Doyle*, 250 F.2d 656, 657 (2d Cir. 1958), *cert. denied* 357 U.S. 938 (1958), the court emphasized that:

> The so-called six months' priority rule is an invasion of the established contract rights of lienholders. As an invasion the rule should be strictly contained within narrow confines and limited to the purposes which brought it into being.

Plainly the rationale of the rule requires, contrary to the view expressed in *Flournoy*, that income diversion to the mortgagees be "the sine qua non of corpus invasion". 301 F.2d at 851.

The cases have held that payments out of income, that should have gone into the current debt fund, made for the benefit of the mortgagees such as payments for principal and interest, *Fosdick, supra* at 253, increments in the mortgage security, *New Haven, supra* at 603, capital improvements to

mortgaged property, *Fosdick, supra* at 253, *Southern Ry. Co.* v. *Carnegie Steel Co.*, 176 U.S. 295 (1900), new acquisitions of property which became subject to the mortgage, *Gregg* v. *Metropolitan Trust Co.*, 124 F. 721, 722 (6th Cir. 1903), *aff'd* 197 U.S. 183 (1905), and, under certain circumstances, payments of equipment trust obligations, *see Southern Railway Co.* v. *Carnegie Steel Co., supra, New Haven, supra* at 603, constitute diversions.

The objecting creditors contend that substantial diversions occurred before and after March 12, 1970, and, accordingly, that the six months creditors are entitled to preferential payment at least to the extent of the alleged diversions. The interline claimants argue that these diversions may be shown in the table set out in the footnote.[7] But it is not enough merely to

[7] The interline claimants contend the items appearing below are shown in Schedule 1 to Exhibit A to the Trustees' answers to interrogatories. It should be noted however that the amount of item 15 in Schedule 1 is $2,600,000, and not $2,590,000 as appears below. It should also be noted that the actual total of the items is $16,332,000, not $14,960,000, as shown below.

Items	
12. Payment to mortgagees:	
Pre-petition (principal and interest)	$ 92,000.
14. Conditional sales contract payments:	
Pre-petition (principal and interest)	675,000.
15. Equipment trust payments:	
Principal and interest	2,590,000.
17. Capital expenditures (less amount financed):	
Equipment and tangible personal property	10,862,000.
Improvements	2,013,000.
Total	$14,960,000.

With reference to item 17. the evidence does not show whether the equipment and tangible personal property were additions, betterments or improvements to mortgaged property. Because "ambiguities must generally be resolved against those claiming benefit of the rule", *In the Matter of New York, New Haven and Hartford R. Co.*, 278 F. Supp. 592, 596 (D. Conn. 1967), ("New Haven"), *aff'd*, 405 F.2d 50, (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969), there can be no presumption that the equipment and tangible personal property effected increments to the mortgage security.

show expenditures for obligations or acquisitions of property that indeed have the appearance of diversions, it must also be proved that the expenditures were made out of funds "kept from those to whom in equity they belong, and used to pay the mortgage debt". *Fosdick, supra* at 253.

The Trustees present a two-pronged argument that no diversions for the benefit of secured creditors occurred.[8]

a.

In the first phase of their argument they stress, in effect, that contributions were made to the income fund from sources other than income from operations, and that such contributions must be considered as a reimbursement pro tanto on account of payments of pre-reorganization secured obligations and for improvements to pre-reorganization mortgaged property. They also argue that payment of Equipment Trust #1, a pre-reorganization secured obligation, resulted in the acquisition of property unencumbered by pre-reorganization mortgage security interest. The Trustees' computation submitted in response to the court's order of February 5 shows that total payments of $7,648,000 of pre-reorganization secured obligations and for improvements to mortgaged property were paid in part from the proceeds of the sale of mortgaged property in

[8] "The total of all payments of pre-reorganization secured obligations and for improvements to property subject to pre-organization mortgages exclusive of such payments made with the proceeds of sale of mortgaged assets and payments which resulted in the acquisition of property unencumbered by pre-reorganization mortgages and security interest — that sum is less than the sum of proceeds of sales of mortgage property and of scrap of mortgage property used to pay operating expenses."

"All of this is wholly without reference to the impact of depreciation. The Trustees . . . submit that so long as the sum of all payments of pre-reorganization secured obligations and additions, betterments and improvements to mortgaged property is less than depreciation, there can be no inequitable diversion in favor of secured creditors which requires the re-creation of a fund for payment of a six month priority."

"Trustees' Brief . . . Order No. 398" at 22-23.

the sum of $2,244,000. The Trustees argue that the remainder of $5,404,000 is more than offset by contributions to operating income from the proceeds of the sales of mortgaged property of $3,079,000, and of scrap of mortgaged property of $2,583,000.

The $2,583,000 were contributed to operating income generally for operating expenses. The $3,079,000 proceeds were paid to settle property taxes outstanding on March 12, 1970.[9] Thus these contributions totalling $5,662,000 may be considered as reimbursement pro tanto to replace revenues used for the payments of secured obligations. *See Central Trust Co. of New York* v. *East Tennessee V. & G. R.R. Co.*, 80 F. 624, 625-26 (6th Cir. 1897). These payments from the proceeds of the sales of mortgaged property were made out of what were referred to in *New Haven*, *supra* at 603, as "free funds", and not out of earnings.

The Trustees' argument that payment of Equipment Trust #1 of $2,600,000 should be an additional offset against the total payment of $7,648,000 because the property acquired is unencumbered, is not persuasive. The parties have not agreed that the acquisition is unencumbered property, and because its status as such is, at best, in doubt, the court has not considered the value of the acquisition an offset to pre-reorganization obligation payments. However, with the $2,600,000 item excluded as an offset it has been demonstrated nevertheless that no diversion for the benefit of the mortgagees occurred as a result of the payments referred to.

b.

The second prong of the Trustees' argument is that no diversions occurred because the depreciation allowance in the income account under the ICC reporting system exceeds the aggregate of all payments made on pre-reorganization secured obligations and for increments to mortgaged property. The depreciation allowance in the income account (Schedule 1 of Exhibit A, item 11) is $33,212,000, an amount in excess of the

[9] Property taxes are railway operating expenses. Exhibit A.

sum of $5,635,000 (payments out of operating income made on pre-reorganization secured obligations) and $12,875,000 (capital expenditures for equipment and tangible personal property and improvements Schedule 1 of Exhibit A, item 17).[10] It is the contention of the interline claimants that "depreciation is irrelevant to the rule", and that in any event because depreciation is an accounting concept "there is no reason to believe that it necessarily reflects the amount of any real deterioration in the value of the equipment involved". Interline Claimants' Brief at 27. In *New Haven* the court pointed out that

> [depreciation] is a reflection of the very real economic fact that the assets are being consumed or wasted away in the process of keeping the railroad running and is actually a measure of the contribution of physical properties made by the mortgagees for this purpose.... Allowance of depreciation is comparable to expenditures made merely to preserve and not to increase the mortgaged assets and as such are not diversions.

278 F. Supp. at 604. The court in *Penn Central* adopted the view expressed in *New Haven*. It must be recognized as a matter of common knowledge that the ordinary wear and tear of railroad assets by operations can be foreseen, and such assets will become exhausted unless measures are taken to keep them in repair or replace them. Physical deterioration of railroad property and equipment caused by operations is inevitable; functional depreciation, perhaps, cannot be foreseen with the same degree of accuracy as physical deterioration but it is an economic fact nevertheless. To offset depreciation it is necessary to take care of the property to maintain its efficien-

[10] In footnote 7, *supra*, the court concluded that on the evidence now before the court the equipment and tangible personal property listed in item 17 of Schedule 1 of Exhibit A was not shown to be increments to the mortgage security. Solely for the purpose of analyzing the Trustees' argument on depreciation the court has treated such property as arguably a benefit to secured creditors, without deciding that it is.

cy, or to replace property when it is no longer efficient, or to set up new assets or reserves to take the place of the losses caused by wear and tear or functional decline. The use of revenues to offset depreciation serves the purposes of Section 77 which are, *inter alia*, to conserve the debtor's assets for the benefit of all creditors and to preserve an ongoing railroad in the interest of the public.

The court rejects the contentions of the interline claimants, and adopts the view of the *New Haven* and *Penn Central* courts that depreciation does not result in enhancement of the mortgaged assets and is not to be regarded as a diversion.

Analysis of this phase of the Trustees' argument is necessary to determine the effect of the allowance for depreciation on the operating income during the relevant period under the six months rule. It is apparent that certain adjustments should be made to the net railway operating deficit of $42,503,000. Reduction of this deficit by disallowing the capital expenditures for equipment and tangible personal property and improvements, totalling $12,875,000, and the payments of pre-reorganization secured obligations of $5,635,000, will eliminate any expenditures which arguably might have benefitted the mortgagees. There should also be disallowed the $3,000,000 of claims of the six months creditors. These reductions result in an adjusted net railway operating deficit of $20,993,000. If these same items are disallowed in the deficit status of income available for fixed charges of $33,216,000 the result is an adjusted deficit of $11,706,000 in that account. Thus, disallowance of the factors which arguably may aid the claims of the six months creditors still leaves a deficit of operating income and income available for fixed charges, demonstrating that there are no earnings available to re-create a current debt fund.

3. *Unmortgaged Assets*

The Trustees claim that they hold certain property unencumbered by the lien of any mortgage. Included in that pro-

perty are items of cash, accounts receivable, wharf property in Portsmouth, New Hampshire, securities and other assets of leased lines and of subsidiary companies, and investment securities. The Trustees also claim as unencumbered property that which was formerly subject to Equipment Trust #1 and their equity in certain equipment and tangible personal property acquired during the reorganization proceedings. These claims are made by the Trustees with realization that the mortgagees may assert some of this property is subject to mortgage liens.

The court has herein declined to view the value of the Equipment Trust #1 property as an offset to pre-reorganization obligation payments, and, accordingly, will not view it as unmortgaged assets at this stage of the Trustees' argument. Similarly the court pointed out that the creditors have not demonstrated that the equipment and tangible personal property in item 17 of Schedule 1 to Exhibit A, see footnote 7 above, were increments to the mortgage security. The court will not review those rulings here. The "unmortgaged assets" aspect of the case will be considered without reference to either the equipment Trust #1 property or the equipment and tangible personal property.

The six months claimants have not argued that "unmortgaged assets" should be deemed a source of current debt fund. Although "unmortgaged assets" were discussed in *New Haven* and *Penn Central* as a source of a current debt fund, in neither case did "unmortgaged assets" become an issue. In their respective discussions, those courts were not in agreement as to whether such assets should be included as a source.[11]

[11] In *New Haven*, use of unmortgaged assets as a source of a current debt fund was based on an earlier Second Circuit decision, *Pennsylvania Steel Co.* v. *New York City Ry.*, 216 F. 458 (2d Cir. 1914), where, as a matter of public policy, the six months creditors were preferred over other creditors, on the strength of the unmortgaged assets of the railroad, because they (the six months creditors) had supported a financially troubled railroad. Judge Fullam, in *Penn Central*, expressed "great difficulty squaring this reasoning with the fundamental basis for a six months priority, namely, reliance of current operations creditors'upon current revenues". 458 F. Supp. 1321, n.81.

Recourse to unmortgaged assets as a source of a current debt fund undermines the rationale of the six months rule, which is that six months creditors in providing goods and services to the railroad, relied for payment upon the income generated by their contributions to the current operations of the railroad, and not upon the railroad's general credit. *See Fosdick, supra* at 252-53. In light of the fact that the six months creditors have not asserted a claim against unmortgaged assets as a source of a current debt fund, and because inclusion of unmortgaged assets in such a fund would not represent restoration of funds "kept from those to whom in equity they belong, and used to pay the mortgage debt", *id.* at 253, the court will not look to unmortgaged assets of the Debtor, if any, as a source of a current debt fund.

For the foregoing reasons, the court concludes that no current debt fund exists or should in equity be re-created and, therefore, that no separate priority classification for six months creditors should be designated.

III. *Necessity of Payment Rule*

The interline claimants and certain other creditors assert a claim for priority founded upon the so-called "necessity of payment rule". The claims are for per diem charges, private car rentals, car repairs, damaged and destroyed cars, and diesel fuel. The parties have stipulated that no creditor claiming under this rule has insisted on payment of its claim as a condition of its providing goods and services to the Debtor, and that the Trustees have never sought authority from the court under this rule for payment of any such claims.

In *Miltenberger* v. *Logansport Railway Company*, 106 U.S. 286 (1882), where the rule was first enunciated, the Court held that where payment of a pre-reorganization claim was necessary for the continued operation of the railroad during reorganization, the court may permit the trustee to pay the claim though it was not entitled to special priority. Justice Holmes pointed out in *Gregg* v. *Metropolitan Trust Co.*, 197

U.S. 183, 187 (1905), that the "ground of such allowance as was made [in *Miltenberger*] was not merely that the supplies were necessary for the preservation of the road, but that the payment was necessary for the business of the road, — a very different proposition".

The necessity of payment rule is not a rule of priority; it is a rule of payment. "The necessity of payment rule is not based on considerations of equity but is rather a device for handling a threat to the continued operation of the railroad during reorganization. If there is no such threat, the rule is not applicable." *New Haven, supra* at 603, n. 15 (underscoring added). Here the evidence and the stipulation demonstrate that the rule is inapplicable, and the claims under the rule must be denied.

IV. *Objections of the United States*

The United States has asserted non-tax pre-reorganization claims against the Debtor which include Federal Railroad Administration safety claims, United States Department of Agriculture loss of damage claims, and Government Accounting Office overcharge and loss and damage claims. Its objection to the Trustees' proposed classification seeks establishment by the court of a separate class for these claims between proposed categories 4 and 5, based upon the provisions of 31 U.S.C. §191.[12] Although the Trustees in their brief disputed the asserted priority, at the hearing on the petition counsel for the

[12] 31 U.S.C. § 191 provides:

"Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed."

Trustees withdrew the objection to the claims of the United States and agreed to the asserted priority provided that the United States prove the conditions specified in 31 U.S.C. §191 for the establishment of the priority. In this regard, both parties agreed to submit to the Interstate Commerce Commission for its determination the question whether the estate of the Debtor is insolvent in the bankruptcy sense. The court has not been informed of any further action in connection with this matter.

V. *Objections of the Town of Madbury, New Hampshire*

The Town of Madbury, New Hampshire objects to the Trustees' proposed classification by claiming that its tax lien on the proceeds of the sale of certain real property is entitled to a priority over all other claims. Class 2 as proposed by the Trustees provides for the proper priority of this tax claim, and no showing has been made of any cogent reason why a separate classification should be created for the tax lien of Madbury, New Hampshire.

VI. *Conclusion*

The court concludes that the fair division of creditors and stockholders on the showing made in these proceedings should have as of the date of entry of this order the following priority under Section 77(c)(7) of the Bankruptcy Act:

1. Administration claims.

2. State and local tax claims against the Debtor which became a lien upon the property of the Debtor prior to March 12, 1970, excepting state and local tax claims to the extent waived by agreement between the Trustees and the taxing authorities.

3. The holders of First Mortgage Bonds.

4. The holders of Income Bonds.

5. Claims of the United States of America under 31 U.S.C. §191.

6. The holders of claims, other than claims secured by valid liens, of federal, state and local governmental authorities

for taxes found by the court to be based on fair and valid assessments and either secured or to have become legally due and owing during the three-year period preceding March 12, 1970, or otherwise to be entitled to priority in accordance with the provisions of the Bankruptcy Act, excepting state and local tax claims to the extent waived by agreement with the taxing authorities.

7. The holder of the 7½% collateral promissory note, dated June 25, 1969, in the original principal amount of $694,042.34 issued to the National Shawmut Bank of Boston, payable serially to June 15, 1970.

8. The holders of secured claims of the Debtor duly proved in this proceeding and allowed by the court, which security interests are subordinate to the mortgages of the First Mortgage Bonds and the Income Bonds.

9. The holders of general unsecured claims against the Debtor duly proved in this proceeding and allowed by the court (whether or not incurred within six months preceding March 12, 1970, and whether or not arising from the provision of goods and services necessary to the Debtor's operations) including without limitation the promissory note of the Debtor given to Southern Railway Association, and all claims arising by reason of the disaffirmance or rejection, or the failure of the Trustees to accept, any executory contract or unexpired lease of the Debtor to the extent of the actual damage or injury sustained, determined in accordance with the principles of the Bankruptcy Act. In addition, all claims of other railroads' per diem charges in excess of those paid by the Debtor during the period August 1, 1953 through March 12, 1970.

10. Five percent preferred Stockholders.

11. Common Stockholders.

/s/FRANK J. MURRAY
Senior District Judge

Dated March 12, 1979

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

In proceedings for the Reorganization of a Railroad
IN THE MATTER OF
BOSTON AND MAINE CORPORATION,
DEBTOR

No. 70-250-M

ORDER ON PETITION OF DEBTOR'S TRUSTEES TO CLASSIFY CREDITORS AND STOCKHOLDERS

After hearing the Debtor's Trustees' petition to fix the division of creditors and stockholders pursuant to Section 77(c)(7) of the Bankruptcy Act, 11 U.S.C. § 205 (c)(7), and the objections thereto, and in accordance with the Court's Memorandum of March 12, 1979, the Court orders that the division of creditors and stockholders in these proceedings be as follows:

1. Administration claims.

2. State and local tax claims against the Debtor which became a lien upon the property of the Debtor prior to March 12, 1970, excepting state and local tax claims to the extent waived by agreement between the Trustees and the taxing authorities.

3. The holders of First Mortgage Bonds.

4. The holders of Income Bonds.

5. Claims of the United States of America under 31 U.S.C. §191.

6. The holders of claims, other than claims secured by valid liens, of federal, state and local governmental authorities for taxes found by the Court to be based on fair and valid assessments and either secured or to have become legally due and owing during the three-year period preceding March 12, 1970, or otherwise to be entitled to priority in accordance with the provisions of the Bankruptcy Act, excepting state and local tax claims to the extent waived by agreement with the taxing authorities.

7. The holder of the 7½% collateral promissory note, dated June 25, 1969, in the original principal amount of $694,042.34 issued to the National Shawmut Bank of Boston, payable serially to June 15, 1970.

8. The holders of secured claims of the Debtor duly proved in this proceeding and allowed by the Court, which security interests are subordinate to the mortgages of the First Mortgage Bonds and the Income Bonds.

9. The holders of general unsecured claims against the Debtor duly proved in this proceeding and allowed by the Court (whether or not incurred within six months preceding March 12, 1970, and whether or not arising from the provision of goods and services necessary to the Debtor's operations) including without limitation the promissory note of the Debtor given to Southern Railway Association, and all claims arising by reason of the disaffirmance or rejection, or the failure of the Trustees to accept, any executory contract or unexpired lease of the Debtor to the extent of the actual damage or injury sustained, determined in accordance with the principles of the Bankruptcy Act. In addition, all claims of other railroads' per diem charges in excess of those paid by the Debtor during the period August 1, 1953 through March 12, 1970.

10. Five percent Preferred Stockholders.

11. Common Stockholders.

SO ORDERED

/s/ FRANK J. MURRAY
Senior District Judge

March 19, 1979

APPENDIX C

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

In Proceedings for the Reorganization of a Railroad
IN THE MATTER OF
BOSTON & MAINE CORPORATION,
DEBTOR

No. 70-250-M

STIPULATION WITH RESPECT TO TRUSTEES' PETITION TO CLASSIFY CREDITORS AND STOCKHOLDERS

Now come the Trustees of the estate in reorganization and the undersigned parties who have heretofore filed objections to the Trustees' Petition to Classify Creditors and Stockholders and, without waiving their respective rights to introduce additional evidence herein, for the purpose of the detemination of that Petition and the Court's division of creditors and stockholders into classes for purposes of the plan and its acceptance, stipulate the following as facts:

1. The information set forth in Exhibit A (including Schedule 1 thereof), D, E, and F to the Trustees' Answers to Interrogatories heretofore filed in these proceedings (the "Answers") as of the dates and periods referred to respectively therein, except that the per diem figures set forth in paragraph 9 of Exhibit D is a total net figure. The amount of disputed per diem claims netted on a mutuality of obligation basis is approximately $8,582,000 (of which $8,018,000 arose prior to August 1, 1969).

2. The information contained in Exhibit B to the Answers as of March 12, 1970, with the qualification that the liabilities therein set forth do not reflect substantial additional claims outstanding against the estate as of March 12, 1970 but asserted subsequent to the date, July 10, 1970, when Exhibit B was prepared.

3. Except as may otherwise be determined by the Court in future hearings on this issue, should such hearings be necessary, the Reorganization Trustees believe that the property described in Exhibit C is unmortgaged. The First Mortgage Trustees claim that a significant part of this property is subject to their mortgage.

4. At the commencement of this reorganization proceeding, the current liabilities of the Debtor arising out of the operation of the railroad, exclusive of loans and notes payable and interest and dividend items, exceeded the Debtor's current assets by a substantial sum. At that time the net book value of the Debtor's total assets exceeded its total liabilities.

5. Subsequent to the initiation of this proceeding, current liabilities of the Debtor which arose out of the operation of the railroad (exclusive of loans and notes payable and interest and dividend items) and which were outstanding on March 12, 1970 were paid and are payable in an aggregate amount in excess of $14,704,000.

6. Of the payments referred to in paragraph 5 hereof, $3,079,000 was paid on account of settlement of $4,618,000 in property taxes outstanding on March 12, 1970. Such tax payments were made with proceeds of the sale of property which was subject to mortgages at and prior to March 12, 1970.

7. In the six months prior to the initiation of this proceeding, the debtor incurred:

(a) a net railway operating loss of $3,588,000;

(b) a total net loss of $5,692,000 before extraordinary items and $5,037,738 after giving effect to extraordinary items; and

(c) a deficit in income available for fixed charged of $3,441,000.

8. From the commencement of these proceedings through July 31, 1978, the estate in reorganization has incurred:

(a) a net railway operating loss of approximately $40,720,000;

(b) a total net loss of approximately $67,524,000 before extraordinary items and approximately $64,216,000 after extraordinary items; and

(c) a deficit in income available for fixed charges of approximately $29,407,000.

9. Substantially all non-operating income accrued during the pendency of this proceeding (Item 6 on Schedule 1 to Exhibit A) has consisted of interest on proceeds of sale of property which was subject tc mortgages outstanding on and before March 12, 1970. These proceeds and the interest thereon have been and are held subject to the same liens that pertained to the property sold and subject to the further order of the Court. Absent the interest on these proceeds, the deficit in income available for fixed charges would approximate $44,000,000 in the period September 13, 1969 through July 31, 1978.

10. Neither in the six months prior to the initiation of these proceedings nor subsequently has there been a payment of principal or interest on the Debtor's First Mortgage Bonds or Income Bonds.

11. In the six months ended March 12, 1970:

(a) total payments on secured and equipment trust obligations amounted to $1,644,000;

(b) capital expenditures amounted to $547,000;

(c) proceeds of sales amounted to $101,000;

(d) depreciation amounted to $2,114,000; and

(e) retirements of property amounted to $758,000.

12. In the period March 13, 1970 through December 31, 1977:

(a) total payments on secured obligations and equipment trust obligations amounted to $7,104,000, of which $3,991,000 was paid on those obligations which were outstanding at March 12, 1970 and $3,113,000 was paid on obligations arising after March 12, 1970 in connection with the Trustees' acquisition of new equipment and tangible property;

(b) of the $3,991,000 paid on secured and equipment trust obligations outstanding in March 12, 1970, $2,244,000 was paid on the secured U.S. Government guaranteed loan from proceeds of sale of property which was subject to mortgages at and prior to March 12, 1970, and the balance was paid from cash flow generated during the period.

(c) capital expenditures (less amount financed) amounted to $12,328,000, of which $10,331,000 was expended for new equipment and tangible personal property out of cash flow generated during the period.

(d) loan-proceeds amounted to $200,000;

(e) property sales amounted to $59,173,000;

(f) depreciation amounted to $31,068,000; and

(g) retirements of property amounted to $111,053,000.

13. All of the equipment lease payments set forth in Item 16 of Schedule 1 to Exhibit A were on straight leases not constituting security agreements or creating security interests.

14. During the period May 1, 1970 through December 31, 1977, the estate in reorganization realized approximately $4,287,000 from sales of scrap. Of this sum, it is estimated that approximately $2,658,000 came from scrap of property which was subject to mortgages at and prior to March 12, 1970. Of these proceeds, approximately $75,000 was deposited in the Registry of Court subject to the mortgages and the balance was used in the operation of the railroad.

15. According to the estate's records, the amount of creditors claims which are asserted to have priority under the so-called "Six Months Rule" is not more than $3,000,000. This figure excludes disputed per diem claims arising prior to September 13, 1969 but includes disputed per diem claims arising in the six months period. With respect to most of the Six Months claims, a priority is also asserted under the so-called "Necessity of Payment" rule. The amount of creditors claims which are asserted to have priority under the "Necessity of Payment" rule, but not the Six Months Rule, is not more than

$400,000. This latter figure also excludes disputed per diem claims arising prior to September 13, 1969.

16. Since December 31, 1977 the estate in reorganization has not made any material payment (i) on a secured debt or an equipment trust obligation outstanding on or before March 12, 1970; or (ii) for improvements to property which was subject to a mortgage at and before March 12, 1970. Capital expenditures for equipment and tangible personal property in said period amounted to $516,198.

17. Nothing herein contained shall be deemed an admission that any particular claimant is entitled to a certain priority status in a specific amount, it being understood and acknowledged that the matter for determination on the Trustees' aforesaid petition is the establishment of classes of creditors and stockholders and their relative priority. Questions as to whether any claimant is entitled to the benefits of a particular class in a specific amount and as to whether the FIRST and SECOND Mortgage Indentures establish a lien on the property described as unmortgaged in Exhibit C are for later detemination in connection with the proof and allowance of claims.

18. With respect to certain claims as to which a priority has been asserted, either in the proof of claim or in an objection to the Trustees' proposed classification, under the so-called Necessity of Payment rule (the "Rule"), it is assumed *arguendo* for purposes of the hearing on October 18, 1978, that certain claimants could prove that said claims arose out of the provision of goods or services either (1) mandated by statute or I.C.C. Rule or Regulation, or (2) which were necessary to some aspect of the operation of the B & M and could not otherwise have been obtained elsewhere by the B & M and which would not have been furnished by such claimants had they known they would not be paid on a current basis. The Reorganization Trustees dispute the facts alleged with respect to any such claim, and proof with respect thereto is reserved

for another date if the resolution of the factual disputes with respect to these claims is ruled by the Court to be necessary for a detemination as to the applicability of the Rule in this proceeding.

However, the undersigned admit that:

(a) So far as the undersigned are aware, no creditor claiming a priority as aforesaid has insisted on payment of its claims as a condition to it providing goods and services; and

(b) The Reorganization Trustees have never sought authority under the Rule for payment of any such claim.

19. The record on the Motions for immediate payment of per diem claims shall be part of the record on the petition for Order No. 398.

ROBERT W. MESERVE AND
BENJAMIN H. LACY,
TRUSTEES IN REORGANIZATION

By their Special Counsel,
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CHESAPEAKE AND OHIO RAILROAD,
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Maine Central Railroad
Portland Terminal Railroad
By their attorneys
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225 Franklin St.
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The Committee of Interline
Railroads
By their attorneys
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Maine Central Railroad
Portland Terminal Company
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Trailer Train Co.
By their attorneys
William Quinn, Esq.

Eastern Associated Coal Corp.
By their attorneys
Philip Burling, Esq.
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10 Post Office Square
Boston, MA 02109

First Mortgage Trustees
By their attorneys
Joseph H. B. Edwards, Esq.
Bringham Dana & Gould
100 Federal St.
Boston, MA 02110

Northern Railroad stipulates to the foregoing subject to the unqualified reservations of its rights and privilege to assert at time of the Hearing on Petition for Order No. 398 and thereafter that the infomation data, and facts stipulated above as the same relate to, bear upon, constitute, or claim to represent the assets, liabilities, and/or financial condition of the Debtor, are misstated to the extent that they fail to recognize and/or acknowledge the Northern's property rights, lien, or trust interest in the estate of the Debtor which Northern asserts must be accorded priority senior to proposed classification 3 as set forth in said Petition.

Northern Railroad Company
By its attorneys
Robert Field, Jr.
Hamblett & Kerrigan, P.A.
11 Concord St.
Nashua, New Hampshire 03061

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

In Proceedings For The Reorganization Of A Railroad
IN THE MATTER OF
BOSTON & MAINE CORPORATION,
DEBTOR

No. 70-250-M

TRUSTEES' ANSWERS TO INTERROGATORIES SUBMITTED RELATIVE TO THEIR PETITION TO CLASSIFY CREDITORS AND STOCKHOLDERS

Now come the Trustees of Boston & Maine Corporation, Debtor herein, and, in answer to the following designated interrogatories, say as follows:

I. *To the Interrogatories Propounded by Respondent Eastern Associated Coal Corporation:*

1. Q. Please state whether or not there exists a Current Expense Fund (also known as a Current Debt Fund, *see In Re* New York, N.H. & H. R.R. Co., 278 F.Supp. 592,599 (D. Conn. 1967)) for the period September 13, 1969 to and including the date of the answer to this question.

A. There exists no Current Expense Fund or Current Debt Fund for the period September 13, 1969 to the date of this answer.

2. Q. Please state the gross amount of operating revenues accrued from September 13, 1969 to and including the date of the answer to this question and which have been actually received or taken over by you.

A. Gross operating revenues of the Debtor for the period September 13, 1969 through March 12, 1970 were approximately $34,047,000. Gross operating revenues of the estate in reorganization were $713,535,000 in the period March 13, 1970 through July 31, 1978 and $747,582,000 in the period September 13, 1969 through July 31, 1978. See Schedule 1 of Exhibit A hereto attached. The Trustees are informed and

believe that they did not actually receive or take over any amount of gross operating revenues accrued in the six months through March 12, 1970. See Exhibit B hereto

3. Q. Please describe by category and amount all depreciation accrued during the period September 13, 1969 to and including the date of the answer to this question.

A. Total depreciation amounted to approximately $2,114,000 in the period September 13, 1969 through March 12, 1970, $31,098,000 in the period March 13, 1970 through December 31, 1977 and $33,212,000 in the period September 13, 1969 through December 31, 1977 as set forth in Schedule 1 of Exhibit A. The categories and amounts of depreciation reflected during the period October 1, 1969 through December 31, 1977 are set forth in Exhibit A.

4. Q. Please describe by ICC account the operating expenses accrued during the period September 13, 1969 to and including the date of the answer to this question which have actually been paid, which are payable by you or which you recognize as expenses of administration herein.

A. The operating expenses of the Debtor, including taxes and rents, amounted to approximately $37,635,000 in the period September 13, 1969 through March 12, 1970 and the operating expenses of the Trustees, including taxes and rents, amounted to approximately $754,255,000 in the period March 13, 1970 through July 31, 1978. Operating expenses, including taxes and rents, in the period September 13, 1969 through July 31, 1978 amounted to $791,890,000. See Schedule 1 of Exhibit A. Operating expenses described by ICC account for the period October 1, 1969 through December 31, 1977 are as set forth in Exhibit A. All operating expenses accrued subsequent to the filing of the reorganization petition have either been paid or are payable by the Trustees as expenses of administration. Of the operations liabilities outstanding on March 12, 1970 (excluding loans and notes payable and dividend and interest items), the Trustees are informed and believe that in ex-

cess of approximately $14,704,000 of such liabilities have been paid and are payable.

5. Q. Please describe any and all assets of the Debtor held by you which are not subject to the lien of any mortgage during the period September 13, 1969 to and including the date of the answer to this question.

A. The Trustees are informed and believe that the property described in annexed Exhibit C is not subject to the lien of any mortgage.

6. Q. Please describe the income received or accrued by the Debtor during the period September 13, 1969 to and including the date of the answer to this question which has been diverted for the benefit of the Debtor's mortgagees or any of them.

A. There has not been diverted for the benefit of the Debtor's mortgagees or any of them income received or accrued by the Debtor during the period from September 13, 1969 to and including the date of this answer.

7. Q. Please state the amount of all payments on account of principal of or interest on any mortgage or deed of trust made by Debtor during the period from September 13, 1969 to and including the date of the answer to this question.

A. As set forth in Schedule 1 to Exhibit A, in the period September 13, 1969 through March 12, 1970 the Debtor made principal payments on U.S. Government guaranteed debt and secured debt to the National Shawmut Bank of Boston aggregating approximately $72,000 and interest payments on such debt aggregating approximately $44,000. No payments of principal or interest were made in that period or subsequently on the First Mortgage Bonds or Income Bonds. In the period March 13, 1970 through December 31, 1977 the estate in reorganization paid approximately $83,000 on post petition mortgage debt and approximately $2,244,000 on U.S. Government guaranteed loans, which latter payment was made from proceeds of sale of property which was subject to mortgages at and prior to March 12, 1970.

8. Q. Please describe all capital expenditures made by the Debtor during the period from September 13, 1969 to and including the date of the answer to this question. In the case of individual items valued in excess of $10,000, please provide specific identification of the items and the amounts.

A. In the period September 13, 1969 through March 12, 1970, the Debtor, as distinguished from the Trustees, made capital expenditures of approximately $547,000 (exclusive of amounts financed). Capital expenditures made by the Trustees in the period March 13, 1970 through December 31, 1977, are set forth on Schedule 1 of Exhibit A. Details of Capital Expenditures in the period October 1, 1969 through December 31, 1977, are included in Exhibit A.

9. Q. Please state the amount of all payments made during the period September 13, 1969 to and including the date of the answer to this question on account of any obligations arising under any conditional sales agreement, equipment trust obligation or lease of personal property for a term greater than one year.

A. Payments made respectively by Debtor and the estate in reorganization on conditional sales agreements, equipment trust obligations or leases of personal property for a term greater than one year in the period September 13, 1969 through December 31, 1977, are as set forth in Schedule 1 of Exhibit A.

10. Q. Please describe the gross operating income accrued during the period September 13, 1969, to and including the date of the answer to this question which has been taken over or collected by you.

A. Assuming that "gross operating income" referred to in this interrogatory means the difference between gross operating revenues and operating expenses *exclusive* of *taxes and rents* prior to January 1, 1978, the gross operating income taken over or collected by the Trustees in the period March 13, 1970 through December 31, 1977, amounted to approximately

$83,700,000. The Trustees are informed and believe that they did not take over any gross operating income generated by the Debtor in the six months ending March 12, 1970, since liabilities outstanding as of March 12, 1970, were paid or are payable subsequent thereto in an amount which exceeded such income or proceeds thereof as was on hand at March 12, 1970. The Trustees have not taken over or collected any net railway operating income or net revenue from railway operations in the period September 13, 1969 to date, as there has been none.

11. Q. Please describe all real property taxes accrued during the period September 13, 1969, to and including the date of the answer to this question and paid or payable by you.

A. During the period March 13, 1970 through July 31, 1978, real property taxes accrued in the amount of approximately $16,024,000. These taxes have been paid or are payable as expenses of administration and in all material respects constituted and constitute liens on the properties on which they were assessed. During the period September 13, 1969 through March 12, 1970, real estate taxes were accrued in the approximate amount of $1,000,000. The Trustees are informed and believe that substantially all of these were unpaid at the commencement of these proceedings together with real estate taxes accrued prior to September 13, 1969. At March 12, 1970, accrued and unpaid real estate taxes aggregated approximately $5,543,325. See Exhibit B. Of these taxes, approximately $4,618,000 has been paid or settled to date with the proceeds of sales of mortgaged property. To the extent not heretofore paid, the Trustees are informed and believe that substantially all such taxes constitute a lien on the property on which they were assessed.

12. Q. Please describe net operating income for the period from March 13, 1970 to and including the date of the answer to this question.

A. In the period March 13, 1970 through July 31, 1978 there was an aggregate net railway operating loss of approx-

imately $40,720,000. In the period March 13, 1970 through July 31, 1978 there was a total net loss of $67,524,000 before extraordinary items and $64,216,000 after extraordinary items.

II. *To the Interrogatories by Members of the Committee of Interline Railroads:*

1. Q. For each classification contained in the Plan and Petition, state the total dollar amount of the claims in said classification.

A. The total dollar amount of claims of each class designated in the Plan is as set forth in Exhibit D hereto.

2. Q. For each month or portion of a month from September 12, 1969 to the present, state the following:

(a) The total cash receipts and the total cash disbursements of the Debtor;

A. The total cash receipts and disbursements of the Debtor in the period September 12, 1960 through December 31, 1969 is unavailable. The total cash receipts and disbursements of the Debtor and the Trustees in the period January 1, 1970 through July 31, 1978 were as set forth on Exhibit E hereto.

2. Q. For each month or portion of a month from September 12, 1969 to the present state the following:

(b) Payments of principal and interest on each and every secured obligation, including, *inter alia*.

(i) Series TT bonds issued under and secured by the First Mortgage Indenture dated December 1, 1969 and Supplemental Indentures;

(ii) Income bonds issued under and secured by the General Income Mortgage Indenture dated July 1, 1940;

(iii) The 7½% collateral promissory note, dated June 25, 1969, issued to the National Shawmut Bank of Boston;

(iv) Any and all equipment trust and equipment lease obligations;

(v) Any and all conditional sales agreements or contracts;

(vi) Any and all other subordinated security interests or devices;

A. Payments of principal and interest on secured obligations other than secured tax obligations in the period September 13, 1969 through December 31, 1977 were as set forth in Schedule 1 of Exhibit A. In the period September 13, 1969 through March 12, 1970, no taxes secured by lien were paid. In the period March 13, 1970 through October 31, 1977 taxes secured by lien were paid or settled in the aggregate amount of $14,675,000.

2. Q. For each month or portion of a month from September 12, 1969 to the present state the following:

(c) Payments of any kind for improvements to the property of the Debtor, including, *inter alia*, additions and betterments to railroad and other property, new equipment purchases and payments for maintenance and repair;

A. Schedule 1 of Exhibit A sets forth the amount of capital expenditures (less amounts financed) made in the period September 13, 1969 through December 31, 1977.

2. Q. For each month or portion of a month from September 12, 1969 to the present state the following:

(d) All deductions taken for depreciation to the property of the Debtor.

A. Deductions for depreciation to the property of the Debtor and its estate in the period September 13, 1969 through December 31, 1977 were as set forth on Schedule 1 of Exhibit A.

3. Q. Identify and state the amounts in all reserve or special accounts or any other funds restricted in any way to use for payment of any principal and interest on obligations to secured creditors, to make payments under equipment trust agreements or leases for capital improvements or maintenance and repairs to property of the Debtor.

A. The identity and amounts of such reserves or special accounts or restricted funds at June 30, 1978 were as set forth of Exhibit F.

Signed under the pains and penanties of perjury.

ROBERT W. MESERVE AND
BENJAMIN H. LACY,
TRUSTEES IN REORGANIZATION

BY: PETER W. CARR
Vice President and Comptroller

BOSTON AND MAINE CORPORATION, DEBTOR

	Pre-Petition (000 Omitted)			6 Mos.	Post-Petition		
	1967	1968	1969	9/13/69 thru 3/12/70	3/13/70 thru 10/31/77	9/13/69 thru 10/31/77	9/13/69 thru 12/31/77
1. Gross Operating Revenues	$62,615	$67,034	$69,454	$34,047	$648,264	$682,311	$696,552
2. Operating Expenses	51,304	55,858	58,617	30,817	561,770	592,587	605,622
3. Taxes#	4,797	5,076	5,373	2,794	58,008	60,802	62,261
4. Rents#	6,237	7,324	8,005	4,024	65,721	69,745	71,172
5. Net Railway Operating Income	277	(1,224)	(2,541)	(3,588)	(37,235)	(40,823)	(42,503)
6. Other Income	1,333	1,235	1,232	521	15,737	16,258	16,961
7. Miscellaneous Deductions	584	820	589	374	6,521	6,895	7,674
8. Income Available for Fixed Charges	1,026	(809)	(1,898)	(3,441)	(28,019)	(31,460)	(33,216)
9. Loan Proceeds	1,250	600	1,044	——	200	200	200
10. Property Sales (Cash including MBTA sales)	1,159	1,181	1,825	101	59,153	59,254	59,274
11. Depreciation	4,155	4,196	4,217	2,114	30,361	32,475	33,212
12. Payments on Mortgages:							
Pre-Petition							
Principal	600	257	518	55	——	55	55
Interest	2,824	2,795	2,802	37	——	37	37
Post-Petition							
Principal	——	——	——	——	67	67	83
Interest	——	——	——	——	——	——	——

"Prior to January 1, 1978, ICC Accounting Rules treated taxes and rents as an expense for purposes of computing net railway operating income, but such expenses were not technically classified as 'operating expenses.' Effective January 1, 1978, taxes and rents are classified as 'operating expenses.' "

BOSTON AND MAINE CORPORATION, DEBTOR

	Pre-Petition (000 Omitted)			6 Mos.	Post-Petition		
	1967	1968	1969	9/13/69 thru 3/12/70	3/13/70 thru 10/31/77	9/13/69 thru 10/31/77	9/13/69 thru 12/31/77
13. U.S. Government Guaranteed Loans:							
Principal	567	567	567	17	2,244	2,261	2,261
Interest	239	211	183	7	—	7	7
14. Conditional Sale Contract Payments:							
Pre-Petition							
Principal	1,527	1,449	541	191	393	584	584
Interest	167	89	37	19	72	91	91
Post-Petition							
Principal	—	—	—	—	1,973	1,973	2,056
Interest	—	—	—	—	905	905	974
15. Equipment Trust Payments:							
Principal	1,234	1,234	1,234	1,234	1,234	2,468	2,468
Interest	181	219	157	84	48	132	132
16. Equipment Lease* Payments	670	1,053	1,271	711	21,049	21,760	21,895
17. Capital Expenditures (less amount financed):							
Equipment and Tangible Personal Property	1,760	4,033	654	531	10,043	10,574	10,862
Improvements	262	542	462	16	1,795	1,811	2,013
18. Retirements of Property	$ 3,214	$ 2,797	$ 1,845	$ 758	$110,520	$111,278	$111,811

*Term more than one year.

BOSTON AND MAINE CORPORATION, DEBTOR
ROBERT W. MESERVE, BENJAMIN H. LACY, TRUSTEES
CONDENSED COMPARATIVE STATEMENT OF INCOME
(ICC BASIS)

JULY 1978	JULY 1977		7 MONTHS ENDED JULY 31, 1978	7 MONTHS ENDED JULY 31, 1977
		OPERATING REVENUES:		
$6,129,479.89	$6,276,365.76	Freight	$48,224,149.27	$47,155,554.44
21,616.39	12,481.33	Switching	133,787.11	107,308.06
211,498.47	126,982.27	Demurrage	1,340,581.85	704,683.60
78,365.08	80,832.53	Net Return from MBTA Operating Contracts	589,814.14	479,650.24
133,437.40	32,496.97	All Other	742,008.81	297,418.61
6,574,397.23	6,529,159.66	Total Railway Operating Revenues	51,030,341.18	48,744,614.95
		OPERATING EXPENSES:		
1,144,399.46	1,239,787.65	Maintenance of Way and Structures	9,826,509.48	10,390,943.00
1,879,436.35	1,818,899.65	Maintenance of Equipment	14,525,277.25	13,432,443.39
3,275,484.71	3,355,632.79	Transportation	22,899,584.51	23,379,401.17
772,922.83	681,458.88	General and Administrative	5,583,772.58	5,253,541.26
7,072,243.35	7,095,778.97	Total Railway Operating Expenses	52,835,143.82	52,456,328.82
(497,846.12)	(566,619.31)	NET REVENUE FROM RAILWAY OPERATIONS	(1,804,802.64)	(3,711,713.87)
402,984.22	593,901.85	Other Income	2,675,827.27	2,655,730.06
(94,861.90)	27,282.54	Total Income	871,024.63	(1,055,983.81)
48,043.79	51,851.57	MISCEL. DEDUCTIONS FROM INCOME	503,368.23	363,630.14
(142,905.69)	(24,569.03)	Income Available for Fixed Charges	367,656.40	(1,419,613.95)

BOSTON AND MAINE CORPORATION, DEBTOR
ROBERT W. MESERVE, BENJAMIN H. LACY, TRUSTEES
CONDENSED COMPARATIVE STATEMENT OF INCOME
(ICC BASIS)

JULY 1978	JULY 1977		7 MONTHS ENDED JULY 31, 1978	7 MONTHS ENDED JULY 31, 1977
		FIXED CHARGES:		
323,789.18	265,348.69	Fixed Interest on Funded Debt	2,260,233.22	1,871,669.78
—	—	Interest on Unfunded Debt	2,281.65	2,281.62
323,789.18	265,348.69	Total Fixed Charges	2,262,514.87	1,873,951.40
(466,694.87)	(289,917.72)	Income after Fixed Charges	(1,894,858.47)	(3,293,565.35)
62,755.00	62,755.00	Interest on Income Mortgage Bonds	439,285.00	439,285.00
—	—	Unusual or Infrequent Items	—	—
62,755.00	62,755.00	Total	439,285.00	439,285.00
(529,449.87)	(352,672.72)	Income (Loss) from Continuing Operations (before Income Taxes)	(2,334,143.47)	(3,732,850.35)
5,600.00	3,000.00	Income Taxes on Ordinary Income	38,900.00	33,400.00
$ (535,049.87)	$ (355,672.72)	INCOME (Loss) FROM CONTINUING OPERATIONS	$(2,373,043.47)	$ (3,766,250.35)

NOTE: 1977 figures have been restated to conform with Interstate Commerce Commission's new Uniform System of Accounts, which became effective January 1, 1978.

s/ P. W. CARR
Vice President and Comptroller

dated: August 28,1978

EXHIBIT B

BOSTON AND MAINE CORPORATION

GENERAL BALANCE SHEET
MARCH 12, 1970

ASSETS

CURRENT ASSETS:		
701	Cash	$ 1,851,024
702	Temporary Cash Investments	3,000
703	Special Deposits:	
	Interest Matured Unpaid	157,644
	Dividends Matured Unpaid	2,407
	Miscellaneous	4,169
704	Loans and Notes Receivable	18,800
706	Net Balance Receivable from Agents and Conductors	4,333,972
707	Miscellaneous Accounts Receivable	3,286,856
708	Interest and Dividends Receivable	60,464
709	Accrued Accounts Receivable	1,215,228
710	Working Fund Advances	191,077
711	Prepayments	591,243
712	Material and Supplies	2,995,532
713	Other Current Assets	(7,170)
	Total	14,704,246
SPECIAL FUNDS:		
715	Sinking Funds	1,492
716	Capital and Other Reserve Funds:	
	Deposits with Trustee in Lieu of Mortgaged Property Sold	1,474,886
	Deposit with Trustee of Equipment Trust Certificates Series 1	48,524
717	Insurance and Other Funds:	
	Investment in Stock of Leased Lines—Pledged (Market Value $1,841,495)	3,650,235
	Cash and Temporary Cash Investments	*1,358,311
	Miscellaneous	70,219
	Total	6,603,667

* Includes $1,300,000 Working Cash Advances to Treasurer.

INVESTMENTS:		
721	Investments in Affiliated Companies—$1,301,226 Pledged	3,786,303
722	Other Investments—$1,868 Pledged	187,730
	Total	3,974,033
PROPERTIES:		
731	Road	154,293,584
	Equipment	64,554,052
	General Expenditures	8,204,269
	Construction Work in Progress	1,730,826
732	Improvements on Leased Property	14,048,735
	Total	242,831,466
735-A	Accrued Depreciation—Road	(12,220,170)
735-B	Accrued Depreciation—Equipment	(34,961,402)
736-B	Accrued Amortization of Defense Projects—Equipment	(1,001,791)
	Total	(48,183,363)
	Transportation Property Less Depreciation and Amortization	194,648,103
737	Miscellaneous Physical Property	1,765,095
738	Accrued Depreciation—Miscellaneous Physical Property	122,120
	Miscellaneous Physical Property Less Depreciation	1,887,215
OTHER ASSETS AND DEFERRED CHARGES:		
741	Other Assets	425,615
742	Unamortized Expense on Long-Term Debt	71,473
743	Other Deferred Charges	972,927
	Total	1,470,015
TOTAL ASSETS		$223,287,279

BOSTON AND MAINE CORPORATION

GENERAL BALANCE SHEET
MARCH 12, 1970

LIABILITIES AND CAPITAL

CURRENT LIABILITIES:		
751	Loans and Notes Payable	$ 2,019,200
752	Traffic and Car Service Balances	3,866,129
753	Audited Accounts and Wages Payable	7,442,063
754	Miscellaneous Accounts Payable	374,728
755	Interest Matured Unpaid	157,644
756	Dividends Matured Unpaid	2,407
757	Unmatured Interest Accrued	1,938,724
759	Accrued Accounts Payable	7,452,424
760	Federal Income Taxes Accrued	111,840
761	Other Taxes Accrued	5,680,108
763	Other Current Liabilities	1,884,134
	Total	30,929,401
DEBT DUE WITHIN ONE YEAR:		
764	1st Mtge. Series TT 6% Bonds, due July 1, 1970	46,337,876
	2nd Mtge. Series A 4½% Income Bonds, due July 1, 1970 (Includes $9,036,720 Interest)	27,863,220
	Equipment Trust Series 1	1,234,000
	Conditional Sales	134,491
	Collateral Trust Notes	566,667
	Collateral Note 7½%, due Serially to June 15, 1970	546,763
	Total	76,683,017
LONG-TERM DEBT:		
	With Fixed Interest:	
765	Collateral Trust 5%, due Serially to June 1, 1974	700,000
	Collateral Trust 5%, due Serially to January 1, 1976	1,500,000
	Collateral Trust 5%, due Serially to October 15, 1977	450,000
	Conditional Sales—Road, due Serially to June 10, 1976	132,878
766	Conditional Sales—Equipment, due Serially to March 1, 1972	122,966
	Total	2,905,844
	Non-Interest Bearing:	
769	Amounts Payable to Affiliated Companies	827,544
	Total	3,733,388

RESERVES:		
771	Pension and Welfare	206,832
773	Equalization	120,293
774	Casualty and Other	1,379,945
	Total	1,707,070
OTHER LIABILITIES AND DEFERRED CREDITS:		
782	Other Liabilities	11,608,002
784	Other Deferred Credits	1,265,239
785	Accrued Depreciation—Leased Property	1,958,024
	Total	14,831,265
CAPITAL:		
Stock:		
791	Outstanding:	
	Common, $1 Par	877,663
	Preferred, $100 Par	8,791,800
	Total	9,669,463
794	Premiums and Assessments on Capital Stock	200,323
795	Paid-in Surplus	99,094,576
796	Other Capital Surplus	984
797	Retained Income—Appropriated	3,801,705
798	Retained Income—Unappropriated (Accumulated Deficit)	(17,363,912)
	Total Capital	95,403,138
TOTAL LIABILITIES AND CAPITAL		$223,287,279

EXHIBIT C

Property Held by Trustees Not Subject to Lien of Any Mortgage[1]

Cash
Accounts Receivable
Warf Property at Portsmouth, New Hampshire
Stock and Assets of Leased Lines:
- Vermont and Massachusetts Railroad
- Stony Brook Railroad
- Northern Railroad

Stocks and Assets of Subsidiary Companies:
- Boston and Maine RR Radio Company
- Connecticut River Valley Co., Inc.
- Mystic Terminal Company
- North Station Hotel Building, Inc.
- North Station Industrial Building, Inc.
- Pine Tree Corp.
- Pullman Company

Other Investment Stock:
- Development Credit Corp. of Maine
- Massachusetts Business Development Corp.
- New Hampshire Business Development Corp.
- Saco Industries, Inc.
- Vermont Development Credit Corp.

Property formerly subject to Equipment Trust Series 1 and the proceeds of such property heretofore sold.

All property purchased subsequent to March 12, 1970 (to the extent not subject to any purchase money security interest).

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[1] The holders of the Debtor's First Mortgage Bonds and/or Income Bonds may claim that certain of the foregoing property is subject to the lien on their respective mortgages.

EXHIBIT D

AMOUNT OF CLAIMS OF EACH TRUSTEES' PROPOSED CLASS OF CREDITORS AND STOCKHOLDERS THE DATES INDICATED

1. Administrative Claims: $21,409,475. An approximate breakdown of these claims is as follows:

Accounts Payable	$3,055,000
Post Petition Borrowing (Including for back time wages)	$5,580,000
Property and other Taxes	$4,978,000
Personal Injury/Freight Claim Reserves	$5,886,000
Damaged and Destroyed etc.	$ 593,000
Con Rail Interline	$ 395,000
Legal, Appraisal and Administrative	$ 658,000
Miscellaneous	$ 264,000

2. State and local tax claims against the Debtor which became a lien upon the property of the Debtor prior to March 12, 1970 excepting state and local tax claims to the extent waived by agreement between the Trustees and the taxing authorities: $1,237,000. This sum does not include interest of approximately $849,000 at December 31, 1977.

3. First Mortgage Bonds: principal - $46,337,876; interest to 3/12/70-$1,711,512. Interest accrued on these bonds from March 12, 1970 through December 31, 1977 approximates $21,700,000. The Indenture Trustee additionally claims interest on interest through December 31, 1977, in the approximate amount of $8,800,000.

4. Income Bonds: principal - $18,826,500; interest to 3/12/70-$9,186,522. Interest accrued on these bonds from March 12, 1970 through December 31, 1977 amounts to an additional $5,874,000.

5. Other Taxes: $11,910.

6. 7½% Collateral Promissory Note dated June 25, 1969, payable to National Shamut Bank of Boston: principal

-$484,994; interest to 3/12/70 - $10,103. Additional interest through December 31, 1977 is or may be claimed in the amount of approximately $272,000.

7. Claims of Secured Creditors whose security interest is subordinate to the liens of the First Mortgage Bonds and Income Bonds: $165,000.

8. General Unsecured Claims (as described in the Plan and Petition): approximately $10,594,000. This amount does not include any claims for damages arising out of the rejection of executory contracts or any deficiency on secured claims.

9. Disputed per diem: $8,136,000.

10. 5% preferred stock, $100 par: $1,260,900. This is net of 74,652 shares held by the Trustees.

11. Common stock, $1 par: $27,644. This is net of 851,168 shares held by the Trustees.

EXHIBIT F

Special Accounts or Restricted Funds for Use on Obligations to Secured Creditors

Account 716 - Capital and Other Reserve Funds
June 30, 1978

Various Bank Depositories and U. S. Treasury Bills—	
Balance of Proceeds—	
Sale of Commuter Lines, etc., to Massachusetts Bay Transportation Authority	$43,149,817
Balance of Proceeds—	
Sale of Reading Line to Massachusetts Bay Transportation Authority	9,701,394
Receivable Due from Boston and Maine's Trustees—	
Reading Line proceeds drawndown to pay back time wages	1,816,452
First National Bank of Boston—	
Pre-bankruptcy sale proceeds held in various investments	1,869,662
Receivable Due from Boston and Maine's Trustees—	
Balance of $1 million borrowing under Revolving Credit Agreement	500,000
United States District Court—	
Minority Stockholders' Suit	34,277
Wolfeboro Rail Road's Note	30,837
Franconia Paper Co.'s Note	1,573
Total	$57,104,012

APPENDIX D

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

In Proceedings for the Reorganization of a Railroad

No. 70-250-M

In the Matter of
BOSTON AND MAINE CORPORATION,
DEBTOR

ORDER

In re Petition for Order No. 398

The Trustees of the Debtor shall file with the court on or before February 13, 1979, the following:

The mathematical computation on which is based the conclusion stated in the Trustees' Brief at the bottom of page 22 and ending at the top of page 23, as follows:

"The total of all payments of pre-reorganization secured obligations and for improvements to property subject to pre-reorganization mortgages exclusive of such payments made with the proceeds of sale of mortgaged assets and payments which resulted in the acquisition of property unencumbered by pre-reorganization mortgages and security interest—that sum is less than the sum of proceeds of sales of mortgage property and of scrap of mortgage property used to pay operating expenses."

The computation shall include the several items involved in the addition and subtraction in the computation, and shall identify the source of each item in the evidence before the court.

Any objecting creditor may file a response to the Trustees' computation on or before February 20, 1979. Notice hereof shall be given the objecting creditors by the clerk by mail forthwith.

(s) FRANK J. MURRAY
Senior District Judge

February 5, 1979

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

No. 70-250-M

In the Matter of
BOSTON AND MAINE CORPORATION,
DEBTOR

TRUSTEES' RESPONSE TO ORDER FOR COMPUTATION RE PETITION FOR ORDER NO. 398

In response to the Court's Order of February 5, 1979 relative to Petition for Order No. 398, the Trustees of the Debtor submit the Computation hereto attached.

The Computation establishes no diversion for the benefit of mortgagees. It is important to also note that the Computation does not reflect the item of depreciation. Depreciation has a material bearing on the question of whether or not there has been a diversion for the benefit of mortgagees. Under both the *New Haven* case and the *Penn Central* case (referred to in our brief), there can be no possible diversion in favor of mortgagees and no Current Expense Fund if the sum of all payments to mortgagees is covered by depreciation, the amount of depreciation used to cover those payments to mortgagees is not used as a deduction in determining net railway operating income and there still remains a deficit in net railway operating income or income available for fixed charges.

Thus even if we were to strike from the Computation the payment on Equipment Trust #1 (item 2(f) on the Computation) and the payments on pre-petition and post-petition tax obligations (items 4(b) and (c) on the Computation), there would still be no diversion and no Current Expense Fund. If we were to make those adjustments to the Computation, line 3 on the Computation would exceed line 4 by $2,811,000.

However, in the period September 13, 1969 through December 31, 1977, depreciation amounted to $33,312,000. Schedule 1, item 11. The $2,811,000 would thus be covered by depreciation, but under Judge Fulham's approach in the *Penn Central* case, the $33,213,000 of depreciation would have to be reduced by $2,811,000 for purposes of determining net railway operating income or income available for fixed charges. However, since there is a deficit in net railway operating income of $42,503,000 (Schedule 1, item 5), and a deficit in income available for fixed charges of $33,216,000 (Schedule 1, item 8), a reduction of the depreciation deduction by $2,811,000 still leaves a substantial deficit in net railway operating income and income available for fixed charges. Accordingly, on the most conservative basis, there has been no diversion for the benefit of secured creditors and there exists no Current Expense Fund.

Respectfully submitted,

ROBERT W. MESERVE and
BENJAMIN H. LACY JR., Trustees

By their Counsel,

(s) CHARLES W. MULCAHY JR.
CHARLES W. MULCAHY JR., Esq.
MULCAHY & MULCAHY
306 Dartmouth Street
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(617) 482-7395

By their Special Counsel,

(s) ROBERT M. GARGILL
ROBERT M. GARGILL
CHOATE, HALL & STEWART
60 State Street
Boston, MA 02109
(617) 227-5020

COMPUTATION

1. Improvements to property subject to pre-reorganization mortgages (9/13/69 - 12/31/77)[1]			$2,013,000[2]
2. Payments of pre-reorganization secured obligations (9/13/69 - 12/31/77)[3]:			
(a) Mortgages	$ 92,000[4]		
(b) U.S. loan:	$2,268,000[5]		
(c) Pre-petition C.S. contracts:	$ 675,000[6]		
(d) Equipment trust:	$2,600,000[7]		
Total [(a) through (d)]		$5,635,000 (Note A)	
Less:			
(e) Payment on U.S. loan:	$2,244,000[8]		
(f) Payment on Equipment trust #1	+ $2,600,000[9]	$4,844,000	
(g) Net payments on pre-reorganization secured obligations:			$ 791,000
3. Total [1 + 2(g)]			$2,794,000
4. (a) Proceeds of scrap of mortgaged property used in operations (5/1/70 - 12/31/77):		$2,583,000[10]	
(b) Pre-petition tax obligations paid with proceeds of sale of mortgaged property:		$3,079,000[11]	
(c) Post petition tax obligations paid with proceeds of sale of mortgaged property (3/13/70 - 10/31/77):		$6,504,000 (Note B)	
(d) Total [4(a), (b) + (c)]			$12,166,000

See Notes A and B attached

---

[1] Per paragraph 16 of the Stipulation, there were no material payments for improvements subsequent to December 31, 1977.
[2] Schedule 1 to Exhibit A to Stipulation ("Schedule 1"), Item 17.
[3] Per paragraph 16 of the Stipulation, there were no material payments on pre-reorganization secured obligations subsequent to December 31, 1977.
[4] Schedule 1, Item 12.
[5] Schedule 1, Item 13.
[6] Schedule 1, Item 14.
[7] Schedule 1, Item 15.
[8] Stipulation, paragraph 12(b).
[9] Stipulation, paragraph 3; Exhibit C.
[10] Stipulation, paragraph 14.
[11] Stipulation, paragraph 6.

NOTE A

Not included in the total of $5,635,000 of payments on pre-reorganization secured obligations is $3,079,000 paid to settle pre-reorganization tax claims aggregating approximately $4,618,000. Although these taxes were secured by liens, we regarded them as operating expenses and not as secured obligations in reaching the conclusion in our brief which is the subject of the Computation. In any event, these taxes were paid with the proceeds of the sale of mortgaged property and would be netted out and therefore not effect the net amount in section 2 of the Computation. See Stipulation, paragraph 6.

NOTE B

This figure of $6,504,000 is the amount paid with the proceeds of sales of mortgaged property to settle approximately $10,057,000 in post-petition taxes. Although such taxes are secured by liens, they are operating expenses and indeed expenses of administration in these proceedings. As set forth on page 9 of the Trustees' Answers to Interrogatories (the third sentence of the first answer on that page), in the period March 13, 1970 through October 31, 1977, total taxes paid or settled amounted to $14,675,000. Of this, $4,618,000 represented taxes outstanding on March 12, 1970, as previously noted. Stipulation, Paragraph 6. The balance, $10,057,000, were post-petition taxes paid or settled, which were satisfied by payments aggregating approximately $6,704,000, of which approximately $6,504,000 was paid from proceeds of sale of mortgaged property. The draw downs (receipts) from proceeds of real estate sales to make this payment and the payment of settled pre-reorganization taxes and the disbursements are reflected in Exhibit E. See Exhibit E for the months of July, November and December, 1974, January through July, 1975, October and November, 1975, February through April, 1976, June and July, 1976, October and November, 1976, March, August and October of 1977.

CERTIFICATE OF SERVICE

I, ROBERT M. GARGILL, hereby certify that I served a copy of the foregoing Trustees' Response to Order for Computation re Petition for Order No. 398, on all objecting parties to the Trustees' Petition to Classify Creditors and Stockholders (Petition for Order 398) by mailing copies thereof, first class, postage prepaid, on February 13, 1979, to the following:

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(s) Robert M. Gargill
Robert M. Gargill

February 13, 1979